Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-1855

EASTALCO ALUMINUM COMPANY,
Petitioner,

v.

PUBLIC SERVICE COMMISSION OF MARYLAND, ET AL.,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF SPECIAL APPEALS OF MARYLAND

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PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF SPECIAL APPEALS OF MARYLAND

Petitioner, Eastalco Aluminum Company, prays that a writ of certiorari issue to review the judgment of the Court of Special Appeals of Maryland in the above entitled case.

JURISDICTION

The Court of Special Appeals issued its opinion on December 12, 1979. (Appendix, p. 13a). The mandate of the Court of Special Appeals was issued on January 11, 1980. (Appendix, p. 11a). A timely Petition for Writ of Certiorari was denied by the Court of Appeals of Maryland on February 22, 1980. (Appendix, p. 1a). The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1257(c) since Petitioner claims the decision of the Court

of Special Appeals of Maryland impairs an obligation of contract in violation of Article 1, Section 10 of the Constitution of the United States.

QUESTION PRESENTED

Whether Orders Nos. 62502 and 62552 of the Public Service Commission of Maryland impaired the obligations of Eastalco's contract with the Potomac Edison Company in violation of Article 1, Section 10 of the Constitution of the United States?

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

Constitution of the United States

Art. 1, § 10

> No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility.
>
> * * * * * *

Annotated Code of Maryland (1957 Edition)

Art. 78, § 26(a) (Volume 7A, page 387)

> *Preferences and discrimination prohibited.*—No public service company shall (with the exceptions listed in the following subsection) directly or indirectly, by any means whatever (including but not limited to special rates, rebates, drawbacks or refunds) in respect of any service rendered or commodity furnished by it:
>
> > (1) Charge, demand or receive from any person a greater or less compensation than from any other person under substantially similar circumstances;

(2) Extend any privileges or facilities to any person except such as are uniformly extended to all persons under substantially similar circumstances;

(3) Give any undue or unreasonable preference to or discriminate against or cause any undue or unreasonable prejudice to, any person, locality, or particular class of service.

* * * * * *

Art. 78, § 27(a) (Volume 7A, page 388)

Rates and charges generally; carriers of flammables.

Prohibited acts.—No public service company shall in its utility operations:

(1) Sell or render service or furnish any commodity until its schedules of rates therefor have been duly filed and published in accordance with § 28(a) of this article.

* * * * * *

Art. 78, § 28(a) (Volume 7A, page 390)

Affirmative duties.

Every public service company shall, in addition to such other duties as may be specifically imposed by this article:

File with the Commission a tariff schedule of its rates and charges. Copies of such schedules shall be plainly printed, shall be open to public inspection, and shall be posted in such manner as to be readily accessible to and conveniently inspected by the public, as may be ordered by the Commission.

* * * * * *

Art. 78, § 68(a) (1979 Cum. Supp., page 87)

General power of Commission; telephone company charges for directory assistance.

The Commission shall have the power to determine just and reasonable rates of public service companies, whether as maximum, minimum or maximum and

minimum, respectively. The rates so determined shall be fixed by order to be served upon each public service company affected thereby.

* * * * * *

Art. 78, § 69(a) (1979 Cum. Supp., p. 88)

Standards for determining rates and charges; lobbying expenses.

"Just and reasonable rates" defined; carriers of flammables excepted.—"Just and reasonable rates" means rates which are not in violation of any of the provisions of this article, which fully consider and are consistent with the public good, and which will result in an operating income to the public service company, except carriers of inflammables, yielding, after reasonable deduction for depreciation and other necessary and proper expenses and reserves, a reasonable return upon the fair value of the company's property used and useful in rendering service to the public.

* * * * * *

Art. 78, § 70 (Vol. 7A, p. 429)

Suspension of rates.

(a) *Suspension of proposed new rate; effective date of rate where not suspended.*—The Commission may suspend, effective forthwith, and without formal proceedings any new rate proposed by a public service company. In such case, the Commission shall furnish to the proponent of the rates suspended a statement, in writing, of the reasons for such suspension. Unless so suspended, any new rate or change in rate proposed by the public service company, shall, subject to § 27(c) of this article, go into effect upon the date specified in the application.

(1979 Cum. Supp., p. 90)

(b) *Proceedings as to justice and reasonableness of rates suspended; duration of suspension.*—The Com-

mission shall promptly institute proceedings as to the justice and reasonableness of the rate suspended. The suspension may be initially for a period of not more than 150 days beyond the time when the rates would otherwise go into effect; and if the Commission finds that the proceedings cannot be completed within the period of the initial suspension, it may extend the suspension for an additional thirty days. After the expiration of 150 days or 180 days, as the case may be, if no final order has been entered by the Commission, the new rate or change in rate proposed by the public service company shall go into effect, subject to subsection (c) of this section.

(Vol. 7A, p. 429)

(c) *Where rate goes into effect before final order in proceedings.*—If a proposed new rate or change of rate effecting an increase goes into effect before a final order is entered in the said proceedings, the Commission may, where practicable, order the proponent to keep a detailed and accurate account of all amounts received by reason of such new rate or increase, and the persons on whose behalf such amounts are paid, and after the conclusion of said proceedings, require the proponent to refund, with interest, to every such person, such part of the new or the increased rates as the Commission finds unjustified. If such refund is not practicable, the company shall charge off and amortize, by means of a temporary decrease, to be fixed by the Commission, below the rates as finally determined, for such period as the Commission may determine, the difference between the operating revenues under the rates charge [charged] and the operating revenues that would have been obtained from the same volume of business from the rates as finally determined.

STATEMENT OF FACTS

Petitioner operates an aluminum reduction plant in Maryland and purchases electricity from the Potomac Edison Company (Potomac), a utility regulated by the

Public Service Commission of Maryland (PSC). Prior to construction of the plant, Petitioner entered into a contract with Potomac, executed in 1967 for an initial term of twenty (20) years beginning March, 1970. The contract was designated as Special Schedule No. 4 and was filed with the PSC among Potomac's tariffs.

Among the many unique provisions of Special Schedule No. 4 was a fuel rate adjustment clause (FRA) which provided that the rates to Petitioner were adjusted each month based upon the cost of fuel at Hatfield's Ferry, a generating station in which Potomac has a partial ownership interest. Until 1972, no other tariff of Potomac was subject to a FRA. The rates of all other customer classes remained constant until increased by the PSC. In 1972, the PSC authorized a FRA for all retail customer classes of Potomac except Petitioner. This FRA adjusted rates each month based upon the system-average cost of fuel. Thus, from 1972 until the decision in this proceeding, Potomac had two FRAs; one applicable to Petitioner and the other applicable to all other retail customer classes.

This matter comes before this Court on two appeals which were consolidated by the Circuit Court of Baltimore City from Orders of the PSC entered in two separate proceedings. As a result of those Orders, the PSC directed that the Petitioner's FRA be deleted from Special Schedule No. 4 and that a uniform FRA based upon system-average fuel costs be applied to all retail customer classes, including Petitioner. This action substantially increased the charges for electricity billed to Petitioner.

On February 2, 1977, Potomac filed with the PSC revised rate schedules for retail electric service to become effective March 4, 1977 designed to produce $16,200,000 in additional gross annual revenues. The PSC suspended the proposed tariffs and instituted Case No. 7038 to determine the justness and reasonableness of the proposed rates.

After extended hearings, the PSC entered Order No. 62502 on August 2, 1977 authorizing a rate increase of $12,361,000 and directing Potomac to file a FRA conforming to the Federal Power Commission (now Federal Energy Regulatory Commission) standard clause, and to make said clause applicable uniformly to all retail customers, including Petitioner. (Appendix, p. 89a). The decision on the latter issue was 2 to 1, with the majority Opinion being adopted by Commissioners Baldwin and Barnes. Commissioner Barnes also filed a Supplemental Opinion. (Appendix, p. 80a). Chairman Hatem, in a Dissenting Opinion, stated that he was unable to concur in the finding as to the application of the uniform FRA to Eastalco. (Appendix, p. 80a). By Order No. 62750, entered on December 5, 1977, the PSC denied Petitioner's Application for Rehearing.

In Case No. 7038, Potomac did not seek any modification of Special Schedule No. 4. A Potomac witness acknowledged some of the unique characteristics of Petitioner and its contract with Potomac. At twenty years' duration, it is much longer than any other customer's contract. Moreover, there are monthly automatic pricing changes for certain pollution control facilities, taxes, loss of accelerated depreciation, federal corporate income tax, and federal investment tax credits. The billing system for Petitioner is simpler and less expensive than the billings to other customer classes. Finally, Petitioner had a FRA in its contract before any other customer class had such a clause.

Most importantly, Petitioner's contract contained a stringent ratchet provision which required Potomac to pay as high as 95% of the monthly charges whether or not it used the electricity. While some industrial customers had ratchet provisions, none approached the severity of Petitioner's clause.

Another witness for Potomac testified on cross-examination that Potomac was under-recovering on the FRA in connection with Petitioner, but he was unable to quanitfy the amount.

The proposal to change Petitioner's FRA originated with Alvin J. Garber, a witness for People's Counsel. He stated that Petitioner should have the standard FRA applied to it. He selected the month of November 1976 and calculated that the system-average fuel cost per KWH was 3 mills higher than the Hatfield's Ferry fuel costs. From this he opined that Petitioner had paid $600,000 less in fuel costs than it should have. On cross-examination, Garber said he did not make a similar calculation for each month of the test year. He did not deny that the figure would be different for each month.

Petitioner presented as its witness James Lim. In Lim's opinion the terms and conditions of Special Schedule No. 4 are integral with the pricing provisions. He noted that the load and service characteristics of Petitioner's operations are unlike any contemplated by the design of the other tariff schedules.

Lim explained the differences between the Eastalco contract and the general tariff schedules. He noted that the Petitioner's contract had an initial term of twenty (20) years with successive five-year renewal periods. The agreement to "take-or-pay" for an extended period of time greatly reduced Potomac's risk of non-recovery of the cost of capacity required to serve Petitioner. Short-term contracts offer less assurance that fixed costs will be recovered economically.

Another distinguishing fact is that Petitioner is Potomac's only 230,000 volt customer. Lim explained that for all other customers whose service voltage is lower than 230,000 volts, Potomac must spend more to provide

facilities for voltage transformation and transmission. Lower voltage facilities are also inherently less efficient from a capacity viewpoint.

Petitioner is subjected to more rigorous notice requirements if it seeks to change load than other customers. It also has a rigid floor on the amount of power it must continue to take and pay for over the life of the contract. Petitioner is restricted to the extent it may lower demand over the life of the agreement (no lower than 230,000 KW) and how rapidly any decrease may be implemented.

In Lim's opinion the special provisions in Petitioner's contract are "all inter-related as integral parts of the overall arrangement, and cannot be properly analyzed and altered on a piecemeal basis."

If the FRA in Petitioner's contract is to be tampered with, then Lim thought all the binding obligations of Petitioner would have to be re-examined and perhaps modified or eliminated. He did not think it appropriate to address the FRA as if it were detached from and independent of the rest of the agreement when it is an integral part of the combination of considerations that went into the contract.

At the conclusion of the case, the majority of the Commission concluded:

> Based upon a careful review of the record relating to this issue, we conclude that the evidence in this proceeding does not support any change in the Eastalco contract, other than the application of a uniform fuel rate adjustment clause to this customer of the Company. (Appendix, p. 76a).

The majority's basis for changing the Eastalco FRA clause was set forth in its Opinion (Appendix, p. 76a) in these words:

> In this proceeding, People's Counsel, through his witness, Mr. Garber, recommended that Potomac Edison's fuel rate adjustment clause be slightly modified so as to conform with the Federal Power Commission standard fuel clause and that this modified clause be uniformly applied to all of the Company's retail customers, including Eastalco. Based upon the evidence on the record in this proceeding, we conclude that it is in the public interest to adopt this recommendation of People's Counsel.
>
> At the present time, the fuel adjustment clause contained in the Eastalco contract is based upon fuel costs incurred in generating electricity at Potomac Edison's Hatfield's Ferry Generating Station. Since the Hatfield's Ferry Generating Station is not dedicated to serve Eastalco, or any other Maryland customer, a proper fuel clause must be based upon the average system fuel costs. In this regard, every other public service company subject to our jurisdiction calculates its fuel rate adjustment on the basis of average system fuel costs; Eastalco is the only user of electricity in Maryland whose fuel rate adjustment is calculated on any other basis.
>
> Accordingly, we will direct Potomac Edison to file a revised fuel rate adjustment clause which conforms with the Federal Power Commission standard clause and which will be uniformly applied to all customers.

Petitioner noted a timely appeal from this decision.

The other proceeding from which Petitioner appeals is PSC Case No. 6759, a generic investigation of the fuel rate adjustment clauses of all major Maryland electric utilities. In that case, by Order No. 62552 entered on August 30, 1977 the PSC directed every major Maryland electric utility to file a FRA conforming to the standard clause of the Federal Power Commission and to apply that clause uniformly to all Maryland customers. (Appendix, p. 93a). While that Order did not have an immediate effect upon

Petitioner, a protective appeal was filed because of the broad language of the Order. All parties agreed below that if Petitioner is successful in the companion appeal, Order No. 62552 must be modified to exclude Petitioner from its effect.

Petitioner appealed the PSC's decisions in Cases Nos. 6759 and 7038 to the Circuit Court of Baltimore City and, after argument, that Court affirmed the decisions of the PSC in a Memorandum and Order dated February 28, 1979. (Appendix, p. 18a). A timely appeal was noted to the Court of Special Appeals of Maryland, and in an unreported, *per curiam* opinion dated December 12, 1979, the Court affirmed the PSC. (Appendix, p. 13a). A timely petition for writ of certiorari was filed with the Court of Appeals of Maryland and that petition was denied by Order dated February 22, 1980. (Appendix, pp. 1a-11a).

The Raising and Disposition Below of the Federal Questions

In its Brief before the PSC prior to the conclusion of the case, Petitioner argued that its contract is protected by the restraint against the impairment of the obligations of contract set forth in Art. 1, § 10 of the Constitution of the United States. (Appendix, p. 91a). Petitioner advanced the same argument in the first step of its appeal in its Pre-Hearing Memorandum to the Circuit Court of Baltimore City. Affirming the decisions of the PSC, Judge Dorf specifically overruled Petitioner's contention that the case law originating in *United Gas Pipeline Co. v. Mobile Gas Service Corp*, 350 U.S. 332 (1956), and *Federal Power Commission v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956), impose constitutional limitations on the authority of the PSC to modify contracts between a utility and one of its customers, (Appendix, p. 22a).

Petitioner then appealed to the Court of Special Appeals of Maryland raising the same grounds. In its Opinion, the Court of Special Appeals noted that:

> It is Eastalco's contention that the doctrine which has become known as the *Sierra-Mobile* doctrine, and which had its origin in the cases of *United Gas Pipeline Co. v. Mobile Gas Service Corp.* (Mobile), supra, and *Federal Power Commission v. Sierra Pacific Power Co.* (Sierra), supra, applies to state regulatory agencies such as Maryland's Public Service Commission. In pursuing this argument Eastalco also maintains that we are presented with a question of constitutional law. (Appendix, p. 15a).

Finally, Petitioner raised the constitutional question in its Petition for Writ of Certiorari to the Court of Special Appeals of Maryland filed with the Court of Appeals of Maryland. (Appendix, p. 5a). That Court denied the Petition on February 27, 1980. (Appendix, p. 1a).

REASON FOR GRANTING THE WRIT

> The Petitioner's contract with Potomac has been impaired in contravention of rights guaranteed by Article 1, Sec. 10 of the Constitution of the United States of America.

Throughout the proceedings, Petitioner has maintained that its contract with Potomac is subject to the doctrine first enunciated in two cases of this Court as developed in subsequent case law. *United Gas Pipeline Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956) (Mobile) and *Federal Power Commission v. Sierra Pacific Power Co.*, (Sierra) 359 U.S. 348 (1956). The Maryland Courts have ruled that the *Sierra-Mobile* doctrine is inapplicable to decisions of the PSC. The Maryland courts further held that the *Sierra-Mobile* doctrine presents no question of federal constitutional law. As a result, Petitioner's contract was impaired without any finding by the administra-

tive agency that the FRA was unduly discriminatory, imposed an excessive burden on other consumers or impaired Potomac's financial ability to continue its service.

This interpretation of the *Sierra-Mobile* doctrine contradicts decisions of other state courts and regulatory agencies.

In *Mobile, supra*, this Court concluded that the Natural Gas Act, a federal statute, did not empower utility companies to change unilaterally their contracts. A gas company (United) had contracted to supply natural gas at an especially low rate for a period of ten years. Before the contract expired, however, United, without the consent of Mobile, filed new schedules purporting to increase the rates. The Commission denied Mobile's ensuing petition to reject the filings, and concluded that under Section 4d of the Act the new rate automatically became effective thirty days after filing unless and until the Commission should, after investigation under Section 4e, determine the new rates were unlawful. Although the lawfulness of the new rates was never determined because Mobile and United negotiated an agreement prior to the Commission's determination, Mobile sued for the difference between the new rate and the contract rate, which it paid prior to reaching the new agreement.

This Court held that Section 4d of the Act did not allow a utility company to change a rate fixed by contract.

> The section says only that a change *cannot* be made without proper notice to the Commission; it does not say under what circumstances a change *can* be made. Absent the Act, a unilateral announcement of a change to a contract would of course be a nullity . . . 350 U.S. at 339. (Emphasis, the Court's).

The Court held in order to change a fixed rate contract, the Commission must first launch an investigation under

Section 5a of the Act. Thus, if after a hearing, the Commission determines the contract rate to be so low as to adversely affect the public interest, it may authorize the utility to file a schedule increasing the rate.

In the companion case of *Sierra, supra*, the Court faced a similar problem. Like *Mobile, Sierra* involved a new rate filed by a utility over the objection of its customer. In *Sierra*, however, the FPC held a hearing and determined that the new or proposed rate was not unduly discriminatory, unjust or preferential, while the old, or contract rate, should be so viewed. The Commission concluded that the contract rate was illegal because it had a return of 2.6% while no return below the 4.75% of the proposed rate would be reasonable. This Court, however, disagreed with the Commission's analysis.

> The Commission's conclusion appears on its face to be based on an erroneous standard. In short, the Commission holds that the contract rate is unreasonable solely because it yields less than a fair return on the net invested capital. But, while it may be that the Commission may not normally *impose* upon a public utility a rate which would produce less than a fair return, it does not follow that the public utility may not itself agree by contract to a rate affording less than a fair return or that, if it does so, it is entitled to be relieved of its improvident bargain. *Cf. Arkansas Natural Gas Co. v. Arkansas Railroad Comm.*, 261 U.S. 379, 43 S. Ct. 387, 67 L. Ed. 705. In such circumstances, the sole concern of the Commission would seem to be whether the rate is so low as to adversely affect the public interest — as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory. 350 U.S. at 354-55. (Emphasis, the Court's).

See also *In Re Permian Basin Area Rate Cases*, 390 U.S. 747, 88 S. Ct. 1344 (1968); *Appalachian Power Co. v. FPC*, 529 F.2d 342 (D.C. Cir. 1976); *Borough of Landsdale*

Penna. v. FPC, 494 F.2d 1104 (D.C. Cir. 1974); *Richmond Power & Light v. FPC*, 481 F.2d 490 (D.C. Cir. 1973); *Indiana & Michigan Electric Co. v. FPC*, 481 F.2d 490 (D.C. Cir. 1973); *Gulf States Utilities Co. v. FPC*, 518 F.2d 450 (D.C. Cir. 1975).

The state courts and commissions which have considered the issue are in substantial agreement that the *Sierra-Mobile* test is a condition precedent to abrogating a contractual rate arrangement, even if the commission itself begins the investigation. The West Virginia Public Service Commission specifically concluded that not only is a utility prohibited from unilaterally raising a fixed contract rate, but a commission may not do so absent a showing that the rate adversely affects the public interest. The commission expressed its agreement with the *Sierra* case and said:

> Thus we hold that there can be no changes in a utility's special contract terms and conditions unless and until the commission, after hearing, determines that the contract rate or provisions are unjust, insufficient, unjustly discriminatory . . ." *Re Columbia Gas of W. Va., Inc.*, 13 P.U.R. 4th 196, 203 (1975).

See also *Re Consolidated Edison Co.*, 4 P.U.R. 4th 199 (1974) and *Agricultural Products Corp. v. Utah Power & Light Co.*, 98 Idaho 23, 557 P.2d 617 (1976); *Central Kansas Power Co. v. State Corp. Comm'n*, 181 Kan. 817, 316 P.2d 277, 285, 287 (1957).

The decision of the Court of Special Appeals of Maryland did not discuss the state cases briefed and cited by Petitioner. It ruled that the Maryland Public Service Commission Law, Md. Ann. Code, Art. 78, § 1 et seq., empowered the PSC to modify the Eastalco contract.

The decision of the Maryland Court of Special Appeals results in different interpretations of the Maryland Act,

the Natural Gas Act and the Federal Power Act, three laws with substantially similar provisions.

This Court interpreted the Natural Gas Act in *Mobile*, and the Federal Power Act in *Sierra*. The relevant portions of the Natural Gas Act are set forth in footnote 1, at 350 U.S. 332, 335 and the Federal Power Act in footnote 1, at 350 U.S. 348, 350. Since the relevant portions of the two Acts are "substantially identical", *Sierra*, 350 U.S. 348, 350, references here will be to the Natural Gas Act. The Act requires in § 4(c) that companies "file with the Commission . . . schedules showing all rates and charges . . . together with all contracts which in any manner affect or relate to such rates . . . ." It further provides in § 4(d) that, "[u]nless the Commission otherwise orders, no change shall be made by any . . . Company in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after thirty days' notice to the Commission and to the public." Section 4(e) of the Act gives the Commission the power to suspend rates and institute proceedings into the lawfulness of the rates. Finally, § 5(a) of the Act allows the Commission to set rates if the rate filed is found to be ". . . unjust, unreasonable, unduly discriminatory, or preferential . . ."

The Maryland law is subtantially similar. Article 78, § 28(a) requires each public utility to, "file with the Commission a tariff schedule of its rates and charges." No rate for electric service may be charged until it has been filed with the PSC. Article 78, § 27(a)(1). When new rates or a change in rates have been filed with the PSC, it may suspend the rates and institute an investigation into the justness and reasonableness thereof. Article 78, § 70. If, after suspension, the PSC determines the rates as filed are not just and reasonable, it may set the proper rates. " 'Just and reasonable rates' means rates which are not in violation of any of the provisions of this article, which fully consider and are consistent with the public good, and

which will result in an operating income to the public service company, . . . yielding after reasonable deduction for depreciation and other necessary and proper expenses and revenues, a reasonable return upon the fair value of the company's property used and useful in rendering service to the public." Article 78, § 69(a). Other "provisions of this article" referred to in § 69(a) include Article 78, § 26(a) which, among other things, states that a utility shall not, "give any undue or unreasonable prejudice to any person, locality, or particular class of service."

This review of the Maryland law illustrates the similarity between the law applicable in the instant case and the rationale of the *Sierra* and *Mobile* cases and supports Petitioner's argument that the *Sierra-Mobile* doctrine should be applied in the instant case. The decision of the Maryland Court of Special Appeals is inconsistent with this Court's decision in *Sierra* and *Mobile* under similar statutes.

Furthermore, the Maryland decision, by virtually eliminating the Contract Clause from consideration in utility regulation in Maryland presents a question not reached in *Sierra-Mobile*. Here, unlike the situation in *Sierra-Mobile*, state action is involved and the Contract Clause question is properly raised.

It has been long recognized that contracts for the provision of electric service are subject to the police power of the state. *Midland Realty Co. v. Kansas City Power & Light Co.*, 300 U.S. 109 (1937). Indeed, paragraph 4(k) of Special Schedule No. 4 acknowledges the power of the PSC to regulate the contract in the proper circumstances. (Appendix, p. 19a). However, this Court has recently noted that, "[i]f the Contract Clause is to retain any meaning at all, however, it must be understood to impose *some* limits upon the power of a state to abridge existing contractual relationships, even in the exercise of its otherwise legiti-

mate police power." (Emphasis in original). *Allied Structural Steel Co. v. Spannous,* 438 U.S. 234 (1978).

In the instant case, the Maryland court has placed no limits upon the power of the PSC to abridge a contract. The PSC based its right to change the FRA clause upon a desire for uniformity and its belief that a proper fuel clause must be based upon system-average fuel costs. (Appendix, p. 76a). The majority Opinion did not find that by virtue of Petitioner's FRA, Potomac's financial ability to continue service was impaired; or that there was cast upon other consumers an excessive burden, or that the FRA resulted in undue discrimination. The decision of the Maryland Court of Special Appeals pushed aside Petitioner's constitutional argument, and having done so, then stated:

> Since we have determined that *Sierra-Mobile* doctrine does not apply to the instant case, it is unnecessary for us to consider the Commission's failure to make findings as required by that tenet. (Appendix, p. 16a).

The Maryland Court, therefore, has placed no limits upon the PSC's actions with regard to contracts. A large industry may have invested large sums of money based upon the provisions of a twenty year electric service contract, but, in Maryland, its faith was misplaced. Unless this Court grants its writ of certiorari, the Maryland PSC may proceed to modify or annul each and every provision of Petitioner's contract which the PSC deems to be favorable to Petitioner until only the more onerous provisions remain.

Under the Maryland Court's decision, no showing is required for this impairment of Petitioner's contract.

CONCLUSION

For the foregoing reasons, we respectfully petition this Court to issue its writ of certiorari.

Respectfully submitted,

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APPENDIX

In the Court of Appeals of Maryland

Petition Docket No. 455

September Term, 1979

(No. 352, September Term, 1979
Court of Special Appeals)

Eastalco Aluminum Company

v.

Public Service Commission of Maryland, et al.

ORDER

Upon consideration of the petition for a writ of certiorari to the Court of Special Appeals in the above entitled case, it is

ORDERED, by the Court of Appeals of Maryland, that the petition be, and it is hereby, denied as there has been no showing that review by certiorari is desirable and in the public interest.

/s/ ROBERT C. MURPHY,
Chief Judge.

Date: February 22, 1980.

In The
Court of Appeals of Maryland

Misc. Docket No.

September Term, 1979

Eastalco Aluminum Company,

Petitioner

v.

Public Service Commission of Maryland, et al.,

Respondents

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF SPECIAL APPEALS OF MARYLAND

Petition for Writ of Certiorari

Petitioner, Eastalco Aluminum Company ("Eastalco"), by Edward F. Shea, Jr., Mary R. Craig and Sherbow, Shea & Tatelbaum, P.A., its attorneys, respectfully requests that a Writ of Certiorari be issued to review the judgment of the Court of Special Appeals of Maryland in *Eastalco Aluminum Company v. Public Service Commission of Maryland, et al.*, No. 352, September Term, 1979 [Exh. No. 1].

Jurisdiction

The jurisdiction of this Court is invoked under Md. Cts. & Jud. Proc. § 12-201 Code Ann. and Rule 810 of Maryland Rules of Procedure.

Grounds for Allowance of the Writ

The Writ should be granted for the following reasons:

1. The Commission's orders violated rights guaranteed Eastalco by Article 1, Section 10 and Section 1 of the Fourteenth Amendment to the Constitution of the United States of America and Articles 19 and 23 of the Declaration of Rights to the Constitution of Maryland.

2. The issue of whether the *Sierra-Mobile* doctrine applies in Maryland has never been addressed by this Court and should be reviewed by the State's highest Court.

3. In ruling that the *Sierra-Mobile* doctrine does not apply in Maryland, the Court of Special Appeals did not discuss the various state court cases and regulatory agency decisions applying the doctrine.

4. The Court of Special Appeals' decision does not set forth the standards which the Commission must meet before a contract, previously filed with the Commission and found to be in the public interest, may be modified.

5. This case presents the issue of what, if any, constraints the constitutional prohibition against the impairment of the obligations of contract places upon the power delegated to the Commission by Art. 78, § 68 of the Annotated Code of Maryland to regulate the provisions of a 20 year contract between an electric utility and a large industrial customer.

Statement of Facts

The case consists of appeals filed by Eastalco from Orders of the Commission entered in two separate proceedings. The appeals were consolidated for purposes of appeal by Judge James A. Perrott on June 2, 1978. The principal appeal is from Order No. 62502 entered on August 2, 1977 in Case No. 7038. By this Order, the majority of the Commission (Chairman Hatem, dissenting) directed that a 20 year contract between Eastalco and The Potomac Edison Company (Potomac) be changed to delete a fuel

rate adjustment clause (FRA)* and to substitute a FRA applicable to all of Potomac's other customer classes. Potomac did not request any modification of the contract. As a result of this modification of Eastalco's contract and the general rate increase granted Potomac, Eastalco was required to pay an additional $5,865,792 in electric rates on an annual basis or 47.59% of the total increase of $12,352,375 authorized for all Maryland customers of Potomac in Case No. 7038.

The secondary appeal is from Order No. 62552 entered by the Commission on August 30, 1977 in Case No. 6759. That case was a generic investigation instituted by the Commission on its own motion to study the FRA of the four major electric generating companies in Maryland. Order No. 62552 entered in that case directed the utilities to use a standard FRA for all customers.

Eastalco appealed these Orders and Order No. 62750 denying Eastalco's Application for Rehearing in Case No. 7038 to the Circuit Court of Baltimore City. That Court affirmed the Commission's Orders on February 28, 1979.

On December 12, 1979, the Court of Special Appeals of Maryland affirmed the Commission's Orders in an unreported *per curiam* decision. The Court of Special Appeals issued its mandate on January 11, 1980.

Questions Presented

1. Whether the *Sierra-Mobile* doctrine applies in Maryland when the Commission considers modification of a contract between a utility and a consumer of electric service which the Commission previously found to be fair and in the public interest?

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* A FRA provides for automatic increases and decreases in electric rates as a function of the cost of fuel to the utility. By Chapter 173 of the Laws of Maryland of 1978, major changes were made in the method by which fuel costs may be recovered by major utilities. This case is governed by the law in effect prior to July 1, 1978.

2. If the *Sierra-Mobile* doctrine applies, whether the Commission's failure to make the findings required by the doctrine requires reversal of the Orders in this case?

3. Whether the Contract Clause of the United States Constitution imposes limits upon the State's power to modify existing contractual relationships?

4. Whether the Commission acted arbitrarily, capriciously and without substantial evidence on the record considered as a whole when it deleted the Eastalco fuel rate adjustment clause?

ARGUMENT

I.

THE APPLICABILITY OF THE *SIERRA-MOBILE* DOCTRINE HAS NEVER BEEN DETERMINED IN MARYLAND AND SHOULD BE DECIDED BY THE STATE'S HIGHEST COURT.

The importance of this appeal to not only the Petitioner but also to the Commission and other interested parties cannot be overstated. The instant case presents a question of first impression in Maryland. Petitioner maintains that the law first enunciated in *United Gas Pipeline Co. v. Mobile Gas Service Corp.*, 350 U.S. 332, 76 S. Ct. 373, 100 L. Ed. 373 (1956) and *Federal Power Commission* v. *Sierra Pacific Power Co.*, 359 U.S. 348, 76 S. Ct. 368, 100 L. Ed. 388 (1956), as developed by the appellate courts and utility commissions of a number of states and now known as the "*Sierra-Mobile*" doctrine applies in the instant case. Although the power of the Commission to regulate utility rates has been acknowledged in Maryland since *Gregg v. Public Service Commission*, 121 Md. 1, 87 A. 1111 (1913), the precise issue presented by this appeal has never been addressed by a Maryland appellate court, prior to this case.

Eastalco operates an aluminum reduction plant in Buckeystown, Frederick, Maryland. Alumina is imported to the Port of Baltimore and is carried by railroad to the plant. There in a series of electric kilns called "pots" the

alumina is refined and cast into slabs or ingots for use by fabricators. At the Eastalco plant there are now two pot lines, each containing 240 pots. The pots require a large amount of electricity, 24 hours a day, 365 days a year. A customer of such unique size and nature of electrical requirements requires a special rate.

On September 6, 1967 Potomac and Eastalco executed an Electric Service Agreement for a 20 year term to begin with the taking of electric service. In 1968 the Agreement was filed with the Commission and was designated Special Schedule No. 4. That contract is a complex, inter-related agreement. By its terms Eastalco was required to complete construction of a first pot line by a given date, or begin paying for electricity. A similar provision with another fixed calendar date applied to a second potline. The Agreement required Eastalco to construct its own substation where the electricity, delivered at 230,000 volts, would be transformed and rectified for use in the plant.

The Eastalco Agreement contained a number of provisions relating to payment for the electricity. Included is a "take or pay" provision whereby Eastalco is required to pay as high as 95% of the monthly charges even if it uses no electricity. In addition there are a series of adjustments or "pass-throughs" to the monthly charges to cover new or increased taxes, investment tax credits, and some of the costs of pollution control facilities. Among those pass-throughs was a FRA based upon fuel costs at a particular generating station known as Hatfield's Ferry. At the time the Eastalco Agreement was executed, as well as at the time service began, Potomac did not have a FRA applicable to any other customer class.

In 1972, for the first time in many years, Potomac filed with the Commission an application for a rate increase. In that rate case (Case No. 6999) Potomac sought and obtained authority to institute a FRA clause for all customers other than Eastalco. That FRA clause was based upon system average fuel costs rather than upon the fuel costs at any particular generating station. In that

same case, the Commission reviewed the Eastalco Agreement, which had been revised by agreement of the parties, and found the Agreement, including the special FRA clause, to be "fair and in the public interest."

Thus, from 1972 until the Commission's decision in this case, Potomac had two FRA clauses for its retail customers, one for Eastalco as embodied in the detailed Agreement, and the other applicable as a rider to its other tariffs.

In the instant case upon the urging of residential customers, the majority of the Commission deleted paragraph (I) (5) from the Eastalco contract and required Eastalco to pay automatic increases under the FRA applicable to all of Potomac's other customers. Eastalco contends that the Commission's 2-1 decision was based solely on a desire to have a uniform FRA for all customers. Eastalco maintains that the majority's action violated the *Sierra-Mobile* doctrine. That doctrine was first applied by the Supreme Court to decisions of the Federal Power Commission (now Federal Energy Regulatory Commission). Succinctly stated, the doctrine provides that a contract rate cannot be modified unless the Commission finds that it is "so low as to adversely affect the public interest — as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." *Federal Power Commission v. Sierra Pacific Power Company,* 350 U.S. at 354-55.

The applicability of the *Sierra-Mobile* doctrine beyond the federal agency which first expressed it was fully briefed and argued before the Court of Special Appeals. As Petitioner's Brief sets forth, courts and regulatory agencies of numerous states have applied the doctrine. Respondents cited in their respective Briefs decisions of other state courts and agencies which declined to apply the doctrine. Despite the extensive argument on this point, the Court of Special Appeals' decision ignored the various cases cited by the parties. In a brief discussion, the Court of Special

Appeals stated it saw no constitutional issue. The Court limited its discussion of the *Sierra-Mobile* doctrine to the two seminal decisions where the contract rate change was sought by the utility, and did not even mention other cases where the court or regulating body found that the doctrine applies even where a regulatory agency seeks to change a contract. See *Gulf States Utilities Co. v. FPC,* 518 F.2d 450 (D.C. Cir. 1975) and *In Re Mississippi Power Co.,* 1 P.U.R. 4th 98 (1973), cited at pages 18 and 19 of Petitioner's Brief.

The *Sierra-Mobile* doctrine, in Petitioner's view, substantially modifies the holding of *Yeatman v. Public Service Commission,* 126 Md. 513, 95 A. 158 (1915). Moreover on the facts, the *Yeatman* case is clearly distinguishable from the instant appeal.

We respectfully urge this Court, as the State's highest Court, to consider and decide this important issue.

II.

The Court Of Special Appeals' Opinion Inadequately Addressed Serious Questions Raised By The Parties.

Petitioner asserted below that the Contract Clause of the United States Constitution restricts the exercise of the State's otherwise broad police power to regulate rates and charges of public utilities. Of course, in the *Sierra-Mobile* case, the Contract Clause was not in issue since both involved appeals from federal administrative agencies. It is an issue when the action of a state regulatory agency is questioned as in the instant case.

This Court discussed the Contract Clause at length in the recent case of *Robert T. Foley Co. v. W.S.S.C.,* 283 Md. 140, 389 A.2d 350 (1978), and the United States Supreme Court recognized the continued vitality of the clause in *Allied Structural Steel Co. v. Spannaus,* 438 U.S. 234, 98 S. Ct. 2716 (1978). The Court of Special Appeals dismissed this constitutional question, stating that, "In pursuing this argument Eastalco also maintains that we are presented

with a question of constitutional law. We are not persuaded by this approach as we do not feel that the cases comprising the *Sierra-Mobile* doctrine are apposite to our situation." (Exhibit 1, page 3).

The parties to this case have waited over two years for a pronouncement from Maryland's appellate Courts regarding the applicability of the *Sierra-Mobile* doctrine and the Contract Clause to the Eastalco situation. As the record on appeal shows, many days of hearings were held before the Commission concerning the Eastalco contract. The issues were fully presented to both the Circuit Court of Baltimore City and the Court of Special Appeals. Moreover, it is a question being considered at the present time by the Commission, and this Court's enunciation of the applicable standards is needed.

The important questions of the applicability of the Contract Clause and the *Sierra-Mobile* doctrine to the Commission's power to modify on a clause-by-clause basis an integrated agreement warrants a full review by this Court.

III.

THE COURT OF SPECIAL APPEALS DID NOT PROVIDE GUIDANCE REGARDING THE STANDARDS TO BE APPLIED BY THE COMMISSION IN MODIFYING A CONTRACTUAL AGREEMENT FOR ELECTRIC SERVICE.

As the record demonstrates, the Eastalco contract was the subject of great controversy during the 1977 rate case, Commission Case No. 7038. Since that time and while this appeal has been pending, Potomac filed an application for additional rate relief. The Commission is currently engaged in proceedings to inquire into what, if any, additional changes should be made to the Eastalco contract. The parties to that proceeding are substantially the same as the parties to the instant case. The issue concerning the proper standards to be applied to the contract will continue to arise in such proceedings. A determination by the State's highest Court regarding this issue will thus be of continuing importance to Eastalco, the Commission, People's Counsel and all other interested persons.

Eastalco is rightly concerned that under the decision of the Court of Special Appeals, its wholly integrated agreement may be emasculated clause by clause, until it is left only with those provisions which impose upon it obligations shared by no other customer of Potomac. Thus, for the remainder of the 20 year term, it could be obligated to pay extraordinary costs because the unique nature of its business is not fully recognized.

Eastalco, as the largest single consumer of electricity from Potomac, will continue to be a party to any proceeding before the Commission regarding Potomac. The Eastalco contract will remain a crucial issue in those proceedings. As the law now stands, Maryland's highest Court has not addressed the issues raised in this appeal, and has not stated what standards the Commission must meet in order to modify the Eastalco contract. If a writ of certiorari is not issued to the Court of Special Appeals, the parties and the significant segment of the public which they represent will lack the guidance which the important issues raised in this appeal merit.

Conclusion

For the reasons set forth above, Petitioner respectfully requests the Court to issue a Writ of Certiorari to the Court of Special Appeals of Maryland.

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Mary R. Craig,
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27th Floor, 10 Light Street
Baltimore, Maryland 21202
(301) 685-6517

Attorneys for Petitioner.

I Hereby Certify that on this day of January, 1980, a copy of the aforegoing Petition was delivered or mailed, postage prepaid, to James A. Pine, Esquire; Kirk

J. Emge, Esquire; John K. Keane, Jr., Esquire; Gary R. Alexander, Esquire; Robert B. Murdock, Esquire, Richard W. Case, Esquire, and Michael A. Pretl, Esquire.

Mary R. Craig

MANDATE

Court of Special Appeals of Maryland

No. 352, September Term, 1979

December 12, 1979 — Per Curiam filed.
Judgment affirmed.
Costs to be paid by appellant.

January 11, 1980 — Mandate issued.

Eastalco Aluminum Company

vs.

Public Service Commission of Maryland

STATEMENT OF COSTS:

In Circuit Court: of Baltimore City

Record	30.00
Stenographer's Costs	

In Court of Special Appeals:

Filing Record on Appeal 30.00

Printing Brief for Appellant and Joint Record Extract 2,135.36

Reply Brief.....
Portion of Record Extract — Appellant .....
Printing Brief for Cross-Appellee.....

Printing Brief for Appellees (203.70 = Potomac) (665.05 = People's) (18.37 = Public Service)
Portion of Record Extract — Appellee .....
Printing Brief for Cross-Appellant.....

STATEMENT OF MARYLAND, Sct:

I do hereby certify that the foregoing is truly taken from the records and proceedings of the said Court of Special Appeals.

In testimony whereof, I have hereunto set my hand as Clerk and affixed the seal of the Court of Special Appeals, this eleventh day of January, A.D. 1980.

HOWARD E. FRIEDMAN,
Clerk of the Court of Special Appeals of Maryland.

Costs shown on this Mandate are to be settled between counsel and NOT THROUGH THIS OFFICE.

Unreported

In The
Court of Special Appeals of Maryland

No. 352

September Term, 1979

Eastalco Aluminum Company

v.

Public Service Commission of Maryland

Thompson, Couch, Weant, Judges

Per Curiam

Filed: December 12, 1979

This is an appeal from the Order of the Circuit Court for Baltimore City dated February 28, 1979 (Dorf, J.), confirming the Public Service Commission (PSC) Orders Nos. 52502, 62552 and 62750. PSC Order No. 62502 was entered on August 2, 1977 in Case No. 7038, giving authority to Potomac Edison Company (Potomac) for a rate increase of Twelve Million, Three Hundred, Sixty-one Thousand Dollars ($12,361,000.00) and directing Potomac

to file a revised fuel rate adjustment (FRA) clause which conformed to the Federal Power Commission's standard clause and which would thereafter be uniformly applicable to all retail customers including Eastalco Aluminum Company (Eastalco). Order No. 62552 was entered on August 30, 1977 in Commission Case No. 6759; it directed all major electrical utility companies in Maryland to file an FRA clause conforming to the Federal Power Commission's standard clause. On December 5, 1977 PSC Order No. 62750 was passed denying all applications for rehearing. Although Case No. 6759 was a generic fuel rate adjustment case, the Order filed therein had no effect on Eastalco, since the PSC had ruled previously on Eastalco's FRA clause in Case No. 7038. As mentioned, Eastalco has appealed from all of the aforementioned orders although the appeal noted from Case No. 6759 is taken in order to preserve whatever constitutional arguments it may wish to raise.

Eastalco purchases electricity from Potomac for the purpose of operating an aluminum reduction plant in Buckeystown, Frederick County, Maryland. Potomac and Eastalco had entered into a contract covering such purchase for an initial term of twenty years from March, 1970. Prior to the Commission's Order in Case No. 7038, the contract between Eastalco and Potomac included an FRA clause which applied only to Eastalco. Order No. 62502 removed from that agreement the FRA clause applicable only to Eastalco and made that company subject to the uniform FRA clause; this in turn caused an annual increase in the cost of electrical purchases to Eastalco of approximately Six Million Dollars. Hence this trip.

In pursuing its appeal, Eastalco has presented the following questions:

> I. Whether the holdings of the Supreme Court in *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 [1956] and *Federal Power Commission v. Sierra Pacific Power Co.*, 350 U.S. 348 [1956] apply to the instant case?

II. If the *Sierra-Mobile* doctrine applies to actions by the Commission, does the Commission's failure to make the findings required by the doctrine require reversal of its Orders?

III. Whether the Commission acted arbitrarily, capriciously and without substantial evidence on the record considered as a whole when it deleted the Eastalco FRA clause and required Eastalco to pay under the FRA clause applicable to other Potomac customers?

I.

It is Eastalco's contention that the doctrine which has become known as the *Sierra-Mobile* doctrine, and which has its origin in the cases of *United Gas Pipe Line Co. v. Mobile Gas Service Corp. (Mobile), supra,* and *Federal Power Commission v. Sierra Pacific Power Co. (Sierra), supra,* applies to state regulatory agencies such as Maryland's Public Service Commission. In pursuing this argument Eastalco also maintains that we are presented with a question of constitutional law. We are not persuaded by this approach as we do not feel that the cases comprising the *Sierra-Mobile* doctrine are apposite to our situation. The compass of *Mobile* is revealed in that case at pages 337-38, as follows: "The question presented is solely one of the proper interpretation of the Natural Gas Act, there being no claim that the statute, if interpreted to permit a natural gas company unilaterally to change its contracts, would be unconstitutional." The scope of the *Sierra* case is set forth at page 349 in the words of Justice Harlan: "This case presents questions under Title II of the Federal Power Act, . . . which are in part similar to those we have decided today under the Natural Gas Act, . . . in United Gas Pipe Line Co. v. Mobile Gas Service Corp., 350 U.S. 332, 76 S. Ct. 373." These cases also differ from our situation in that the issues involved the legality of a public utility unilaterally making rate changes in excess of the rate set forth in existing contracts. In the case *sub judice* the change sought was instigated by the Public Service Commission pursuant to its delegated powers. Potomac

appears to have had no part in requesting such action, although we now hear no protestations from that quarter. Consequently, we are constrained to hold that the circumstances facing us dictate a negative answer to the first question propounded by the appellant.

II.

Since we have determined that the *Sierra-Mobile* doctrine does not apply to the instant case, it is unnecessary for us to consider the Commission's failure to make findings as required by that tenet.

III.

The final question to be determined is whether the Commission acted arbitrarily, capriciously and without substantial evidence on the record when it changed the FRA clause set forth in the contract existing between Potomac and Eastalco.

Maryland Code, Art. 78, § 97 speaks of the scope of review of the decisions of the Public Service Commission as follows:

> Every final decision, order, rule or regulation of the Commission shall be prima facie correct and shall be affirmed unless clearly shown to be (1) in violation of constitutional provisions, or (2) not within the statutory authority or jurisdiction of the Commission, or (3) made under unlawful procedure, or (4) arbitrary or capricious, or (5) affected by other error of law, or (6) if the subject of review is an order and in a contested case after hearing, such order is unsupported by substantial evidence on the record as a whole.

After quoting this statutory authority, the Maryland Court of Appeals in *Potomac Edison Co. v. PSC*, 279 Md. 573 (1977) commented as pages 582-83 as follows:

> Consequently, decisions of the commission are prima facie correct, and its judgment is accorded the respect due an informed body that is aided by competent and experienced staff. *Balto. Trans. Co. v.*

> *Pub. Ser. Comm.*, 206 Md. at 558. Our inquiry, then, is limited to a determination of whether there was illegality or unreasonableness in the commission's action; when that inquiry is finished, judicial scrutiny ends and the judicial function in the rate making process is over. *Balto. Gas Co. v. McQuaid*, 220 Md. 373, 382, 152 A.2d 825 (1959). In recognition of our limited role, therefore, we have repeatedly held that a reviewing court may not substitute its judgment for that of the commission. *Public Serv. Comm'n v. Balto. Gas & El.*, 273 Md. at 362.

The trial court obviously followed these well-established dictates and found no basis on the record to hold that the Commission's decision was arbitrary, capricious, unreasonable or unsupported by substantial evidence, nor can we. That Eastalco is unlike any other customer or customer class dealing with Potomac does not persuade us that the Commission's decision was unreasonable when considered in light of all the pertinent facts contained in the record.

Judgment Affirmed.
Costs to be paid by Appellant.

In The
Circuit Court of Baltimore City

1977/A-838/A-57205

1977/A-750/A-57010

Eastalco Aluminum Company,

Appellant

vs.

Public Service Commission of Maryland,

Appellee

MEMORANDUM AND ORDER

This appeal by Eastalco Aluminum Company ("Eastalco"), Appellant, arises out of two Orders of the Public Service Commission of Maryland ("PSC"). Although initially two appeals were filed, they were consolidated by Judge James A. Perrott on June 2, 1978.

Eastalco's principal contention stems from PSC Order No. 62502 entered on August 2, 1977, in Case No. 7038, a case originally instituted by the Potomac Edison Company ("Potomac") to increase rates charged to ratepayers in Western Maryland. This appeal is also from Order No. 62750 entered by the PSC on December 5, 1977, denying all Motions for Rehearing.

The companion appeal is from Order No. 62552 entered on August 30, 1977, in Case No. 6759. This case was a generic investigation by the PSC into the fuel rate adjustment ("FRA") clauses of all Maryland electric utilities. In this order, the PSC directed every Maryland electric generating company to use a fuel clause that

conforms with the Federal Power Commission standard clause and to uniformly apply that clause to all Maryland customers.

On February 13, 1979, a hearing was held before Judge Paul A. Dorf. Present were Joseph Sherbow, Esquire, Edward F. Shea, Jr., Esquire, and Mary R. Craig, Esquire, attorneys for Eastalco, Appellant; James A. Pine, Esquire, attorney for the PSC, Appellee; Richard W. Case, Esquire, and Robert C. Fowler, Esquire, attorneys for Potomac; and John K. Keane, Jr., Esquire, People's Counsel.

Before this Court considers the ramifications of the PSC actions, several factors must be noted. The first is the plethora of events between all parties dating from 1968 to the present. Quite conspicuously, counsels' arduous memoranda are more than adequate in this respect, and it is not necessary to deluge this opinion with excess verbiage.

Second, however, is a fine point of the contractual agreement between Eastalco and Potomac. Paragraph 4 (K) of the Electric Service Agreement states:

> "The provisions of this Agreement and the charges provided for herein are subject to regulation by the Regulatory authorities having jurisdictions."

The PSC subsequently is identified as a regulatory authority having jurisdiction.

The third and most crucial factor is this Court's scope of judicial review. The Annotated Code of Maryland, Art. 78, § 97 (1975 Repl. Vol.), in its sagacity, provides:

> "Every final decision, order, rule or regulation of the Commission shall be prima facie correct and shall be affirmed unless clearly shown to be (1) in violation of constitutional provisions, or (2) not within the statutory authority or jurisdiction of the Commission, or (3) made upon unlawful procedure, or (4) arbitrary or capricious, or (5) affected by other error of law, or (6) if the subject of review is an order entered in a

> contested case after hearing, such order is unsupported by substantial evidence on the record considered as a whole."

This limitation is embellished further by a finding that a reviewing court will not substitute its judgment for that of the Commission, and that an order of the Commission will not be disturbed on appeal except upon clear and satisfactory evidence that it is unlawful or unreasonable. *Public Service Commission v. Baltimore Gas & Electric Company*, 273 Md. 357, 362 (1974).

Consequently, with this perspective, the question before this Court is whether the PSC acted within the ambit of pertinent statutory, case and constitutional law.

The powers of the PSC are delineated in Article 78, Annotated Code of Maryland. Section 56 imposes upon the Commission a duty to regulate the rates and service of utilities in Maryland in the public interest. Section 68(a) gives the Commission the explicit power to regulate rates filed by the State's public service companies:

> "The Commission shall have the power to determine just and reasonable rates of public service companies, whether as maximum, minimum or maximum and minimum, respectively. The rates so determined shall be fixed by order to be served upon each public service company affected thereby."

Sections 27, 28 and 70 expand on the statement of authority given by Section 68. The utilities are required by Section 28 to file tariff schedules of their rates. Section 70 outlines a procedure for review of the rate schedules. Section 27 forbids the utilities to charge rates for service other than as outlined in its tariff schedule.

Finally, Section 26(a) expressly prohibits a public service company from charging unreasonably preferential rates. This section states:

> "*Preferences and discrimination prohibited.* — No public service company shall (with the exceptions

listed in the following subsection) directly or indirectly, by any means whatever (including but not limited to special rates, rebates, drawbacks or refunds) in respect of any service rendered or commodity furnished by it:

"(1) Charge, demand or receive from any person a greater or less compensation than from any other person under substantially similar circumstances;

"(2) Extend any privileges or facilities to any person except such as are uniformly extended to all persons under substantially similar circumstances;

"(3) Give any undue or unreasonable preference to or discriminate against or cause any undue or unreasonable prejudice to, any person, locality, or particular class of service."

Admittedly the regulatory powers of the PSC are broad. Yet in the case *sub judice* the exercise of those powers was proper. The Electric Service Agreement between Eastalco and Potomac is nonetheless a contract between a utility and a customer. The PSC, with the Legislature's blessing, *shall regulate and establish just and reasonable rates* [emphasis supplied]. To ignore the monetary disparity between Eastalco's FRA clause and the FRA clause of other customers is a slight wholly inconsistent with the PSC's mandated duty and the general welfare of the public.

In Maryland, *Gregg v. Public Service Commission of Maryland*, 121 Md. 1 (1913), recognized that rate making is a legislative function, i.e., subject to the powers of the PSC. The Court of Appeals reaffirmed this principle in *Public Service Commission v. Baltimore Gas & Electric Company, supra.*

Yeatman v. Public Service Commission, 126 Md. 513 (1915), clearly establishes the authority of the PSC to exercise the police powers of the State in its regulation of public utility rates. This police power, in accordance with PSC law is paramount to any private contract between a utility and a customer. The Court said:

> "Contracts, even between individuals, when entered into are necessarily subject to the control of the police power of the State, whenever such contract relates to matters which are or may be subject to the exercise of such powers. . . . Some of the cases which have dealt with situations where there had been an establishment of rates directly by the Legislature, have distinctly denied the theory that such legislative establishment rates constituted any contract whatever, and have held, accordingly, that the rates established were liable to change at any time by the legislative authority which had originally enacted them" *Id.* at 518-519.

Thus, modification of a rate in a contract between a public utility and a private customer by the PSC does not constitute an impairment of the obligation of contract.

In *Midland Realty Co. v. Kansas City Power & Light Co.*, 300 U.S. 109 (1937), the Supreme Court also recognized that rate setting is a legislative function:

> "[T]he State has power to annul and supersede rates previously established by contract between utilities and their customers. It has power to require service at nondiscriminatory rates, to prohibit service at rates too low to yield the cost rightly attributable to it, and to require utilities to publish their rates and adhere to them" *Id.* at 113.
> See *Union Dry Goods Co. v. Georgia Public Service Corp.*, 248 U.S. 372, 377 (1919).

Both *Yeatman* and *Midland Realty* are patently clear and instructive. The police power of the State manifested through a public service commission, in this case the PSC, transcends any private contract between a utility and a customer as long as the regulations are in accordance with the respective public service commission law. Such is the case here.

The thrust of Eastalco's argument is that two decisions of the Supreme Court, *United Gas Pipeline Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956), and *Federal Power*

Commission v. Sierra Pacific Power Co., 350 U.S. 348 (1956), impose constitutional limitations on the authority of the Commission to modify contracts between a utility and its customers. The *Sierra-Mobile* doctrine involves the interpretation of the Natural Gas Act, 15 U.S.C.A. §§ 717 *et seq.*, and the Federal Power Act, 16 U.S.C.A. §§ 824 *et seq.* It is this Court's opinion that no constitutional question exists in those cases. Furthermore, both cases are not germane to the issue *sub judice*. In *Sierra-Mobile*, the Supreme Court based their decisions on statutory grounds in light of specific sets of facts presented in those proceedings.

Assuming, arguendo, that the *Sierra-Mobile* case law is applicable, the findings of the PSC would still stand. Testimony from the record extracts supports a conclusion that Eastalco's FRA clause is unreasonable and discriminatory. The two distinct FRA clauses create a disparity among all other Potomac customers which will grow with the rise in fuel costs used to generate electricity.

Specifically, in reaching this determination, the PSC relied on the testimony of Mr. Alvin J. Garber, called by People's Counsel [E. 730-746]. His testimony, in part, contained the following:

> ". . . There is nothing to show that something different from the standard retail fuel adjustment clause, which is applied to every other retail sale, should not be applied to the Eastalco sale." [E. 736]
>
> "Because Eastalco's fuel clause contains an improperly low adjustment factor, the disparity between system fuel cost and what Eastalco is being charged will become ever greater if the cost of fuel continues to increase, as seems probable. [E. 737]

He concluded with:

> "Eastalco, in its rates, is not being charged its fair share of system fuel costs. To the extent that it is not paying such fair share, it is placing an undue cost burden on the other customers of the company. The

> Commission should order that its basic rate structure be revised to include the same fuel cost component as for the other retail customers and the standard retail fuel adjustment clause be substituted for the one now in use." [E. 737-738]

After weighing all the evidence, the PSC stated:

> "In this proceeding, People's Counsel, through his witness, Mr. Garber, recommended that Potomac Edison's fuel rate adjustment clause be slightly modified so as to conform with the Federal Power Commission standard fuel clause and that this modified clause be uniformly applied to all of the company's retail customers, including Eastalco. Based upon the evidence on the record in this proceeding, we conclude that it is the public interest to adopt this recommendation of People's Counsel." [E. 973-974]

This Court does not disagree with the PSC's conclusion. Nor does it agree with Eastalco's argument that the PSC changed their rates for the sole purpose of making all utility rates uniform. The record clearly contains a substantial basis for the PSC decisions; decisions which abrogate unjust discrimination and preference in the public interest.

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Finally, this Court must once again scrutinize its scope of judicial review. The test is set forth below:

> ". . . The judicial review essentially should be limited to whether a reasoning mind reasonably could have reached the factual conclusion the agency reached. This need not and must not be either judicial fact-finding or a substitution of judicial judgment for agency judgment." *Insurance Commissioner v. National Bureau*, 248 Md. 292, 309-310 (1967).*Supervisor of Assessments of Baltimore County v. Banks*, 252 Md. 600, 609-610 (1968).

The application of this test compels a holding that the PSC decisions were not erroneous as a matter of law and that they were supported by substantial evidence appearing in the record.

Therefore, IT IS this 28th day of February, 1979, ORDERED by the Circuit Court of Baltimore City that the Public Service Commission Orders Nos. 62502, 62750 and 62552 (Cases Nos. A-57205 and A-57010 in the Circuit Court for Baltimore City) are hereby AFFIRMED.

PAUL A. DORF, Judge.

cc: All Attorneys

Before The
Public Service Commission Of Maryland

Case No. 7038

In The Matter of the Application of the Potomac Edison Company for Revisions In its Electric Rates.

Appearances:

John K. Keane, Jr., People's Counsel; Philip S. Shapiro, Junior Assistant People's Counsel; Henry R. Lord, Special People's Counsel; and Thomas E. Plank, Special People's Counsel.

Joseph Sherbow and Edward F. Shea, Jr., for Eastalco Aluminum Company (Eastalco).

Harrison M. Robertson, Jr. and William C. Stifler, III, for Celanese Fibers Company.

Martin H. Freeman, for Louise Fahrney, Sylvia Hancock, Edythe Richard and Kenneth Ridenour (OCJ).

Robert B. Murdock, Richard W. Case and Michael A. Pretl, for The Potomac Edison Company.

By the Commission *Filed: August 2, 1977*

OPINION

On February 2, 1977, The Potomac Edison Company (hereinafter sometimes referred to as "Potomac Edison" or "Company") filed with the Commission revised rate schedules for retail electric service, to become effective March 4, 1977. The revised schedules were designed to produce

$16,200,000 in additional gross annual revenues, an increase of approximately 16 percent.

By Order No. 62110, entered in these proceedings on February 14, 1977, the Commission suspended, for a period of not more than 120 days from March 4, 1977, the proposed increases in rates filed by the Company and instituted proceedings as to the justice and reasonableness thereof. Thereafter, by Order No. 62404, entered on June 13, 1977, the Commission extended the suspension period of the proposed rate increases for an additional 30 days, or a total of 150 days, the maximum period authorized by law.

In order to provide a convenient opportunity for members of the public to present testimony on Potomac Edison's proposal, the Commission scheduled, advertised and held evening sessions of the hearing at four locations within the Company's service area. These sessions of the hearing were held in Cumberland (May 16, 1977) Frederick (May 18, 1977), Hagerstown (May 25, 1977), and Damascus (June 7, 1977).

TESTIMONY OF WITNESSES

For the Company.

The first witness to testify on behalf of the Company was John M. McCardell, Executive Vice President and General Manager of Potomac Edison.

The witness stated that for several decades growth in both usage and kilowatt-hour demand in the Company's service area was at a level higher than national averages. However, he noted that in the latter part of 1973, the growth rate lessened as a result of conservation of energy by customers and a downturn in the regional economy. The witness concluded that the effect of conservation efforts appears to have been a temporary, one-time occurrence; the Company is of the opinion that the future needs for electricity will resume the historic pattern of

growth at a rate which is slightly less than the rate which was experienced in the past.

To meet these projected customer requirements, Potomac Edison will require, he said, over 1,000 megawatts of new generation at a total present estimated cost of approximately $750,000,000. According to Mr. McCardell, these figures represent the requirements for new generating capacity only and do not include needed investment in transmission, distribution and other electric facilities that also must be financed in the future.

During the five-year period ended December 31, 1975, Potomac Edison made additions to its electric property in an amount which totalled approximately $211,000,000, while construction expenditures for 1976, 1977 and 1978 are estimated to be $67,000,000, $88,000,000 and $92,000,000 respectively. For the years 1977 to 1981, the Company estimates that it will have to spend about $489,000,000 on its total construction program, which represents an average yearly expenditure during that five-year period of approximately $98,000,000.

According to Mr. McCardell, the rates which the Company is seeking in this proceeding are those which will produce an earnings level that is sufficient to attract capital from investors. Without this additional capital, he said, Potomac Edison will be unable to finance its construction program and therefore, will be unable to provide for the future demands of its customers.

In Mr. McCardell's opinion, the principal cause requiring the Company's request for a rate increase is inflation. In this regard, he noted that there have been inflationary increases in costs of materials and supplies used in the daily operation of the Company and in its construction program. Furthermore, the impact of inflation has been magnified, the witness stated, in capital intensive industries as a result of long-term inflationary trends. For example, when a 30-year old bond issue with 3 percent interest cost came due in 1974 and was replaced by a new

bond issue at 11 percent, the interest cost almost quadrupled.

In Mr. McCardell's opinion, the most significant problem facing Potomac Edison is the large gap between the forecasted cost of electric facilities that should be constructed to meet future demands of customers and the costs which the Company can finance based upon regulatory decisions in recent rate cases. In the future, he said, the Company will estimate what rate levels it can reasonably expect, based upon this and previous rate cases. By projecting the funds it can reasonably expect to have, Potomac Edison will match those funds with the best construction program which it believes it can finance. If this program falls short of customers' demand, curtailment programs will become necessary.

James W. Nicol, Comptroller of the Company, was the next witness to testify in this proceeding on behalf of Potomac Edison.

Through this witness, an exhibit was introduced which indicated that for the 12-month period ended December 31, 1976, the Company had adjusted Maryland jurisdictional net operating income of $15,264,724, which is calculated in detail in Appendix A to this Opinion. Another exhibit which was prepared by Mr. Nicol indicated that the Company's Maryland jurisdictional rate base was $252,363,829 as of December 31, 1976 and averaged $240,417,135 for the 12-month period ended December 31, 1976. Both of Mr. Nicol's rate base determinations are set forth in Appendix B to this Opinion.

In arriving at the aforementioned Maryland jurisdictional net operating income and rate base calculations, the witness made certain adjustments to the Company's book figures. First, an adjustment was made which reduced the Company's jurisdictional revenues by $1,476,214 in order to eliminate the 1976 portion of Potomac Edison's temporary fuel rate surcharge (effective September 1, 1975 to September 30, 1976).

The second adjustment which was made by this witness removes $4,298,783 in jurisdictional revenues which were attributable to an abnormal sale. This sale represents a single, short-term transaction for the period of January to April, 1976, with the General Public Utilities System (GPU) for the purpose of covering the consecutive outages of two nuclear generating units. According to Mr. Nicol, this sale was abnormal because of the amount of capacity requested by GPU within a short period of time. Moreover, this situation will not occur again, since Allegheny Power System (APS) will not have the capacity to meet such a request if it should occur in the future.

A related adjustment was made which reduced the Company's jurisdictional operating expenses by $3,567,832, in order to remove those expenses which were associated with the abnormal sale to GPU. In addition, Potomac Edison, in recognition that absent the sale to GPU it would have had more opportunity to make economy energy sales, included an amount to reflect its projection of such sales.

Another adjustment which was made by Mr. Nicol reflected Potomac Edison's employee wage increases and personnel reductions within the test period and beyond the test period but before a final decision is anticipated in this case. The net effect of these adjustments was to increase the Company's operating expenses by $653,154.

An adjustment which increased test year operating expenses by $43,500 was made to amortize the rate case expense associated with this proceeding over a period of two years. According to this witness, two years is the maximum time the Company can reasonably anticipate between rate cases, given the present state of the economy.

The witness also made two adjustments in order to reflect certain changes in the Power Supply Agreement between Potomac Edison, Monongahela Power Company and West Penn Power Company. In this regard, an adjustment which increased Maryland jurisdictional oper-

ating expenses by $38,441 was made in order to reflect an increase in the capacity charge which became effective on January 1, 1977. In addition, Mr. Nicol stated that an application is being filed with the Federal Power Commission to increase the rate of return under the Power Supply Agreement from a present rate of 8 percent to a more realistic level of 9.25 percent. As a result, the Company is proposing to increase its jurisdictional operating expenses by $1,153,260 in order to reflect this change.

With respect to the calculation of the Company's cash working capital requirement, the witness stated that, as in the past, the Company has conducted a lag study in order to determine its net revenue lag. The total cash working capital requirement which was determined under the Company's lag study was $11,668,058, of which $6,662,370 was attributable to the Maryland jurisdiction.

In this proceeding, the Company is advocating the use of a terminal rate base. In this regard, the witness noted that it has been more than 28 months since Potomac Edison filed its last application for a rate increase. The Company, he maintained, was able to defer a rate increase application for this period of time as a result, in large part, of favorable short-term sales in early 1976. However, the Company has unquestionably suffered, he said, from attrition of earnings and will surely be subject to additional attrition once its new rates are permitted to go into effect.

Potomac Edison is also seeking in this proceeding authority to cease capitalizing an Allowance for Funds Used During Construction (AFUDC) for rate making purposes. The witness noted that since the Company's last rate increase application (Case No. 6786), the Commission has authorized Baltimore Gas and Electric Company to cease capitalizing AFUDC on all of its construction projects except Calvert Cliffs Unit No. 2. As a result of this action, and the Commission affirmation of this principle in other rate cases, Potomac Edison ceased capitalizing AFUDC on its construction applicable to Maryland opera-

tions effective November 1, 1975. The exhibits presented by Mr. Nicol are consistent with the Company's books and reflect this change for the entire test period.

Frank J. Hanley, Senior Vice President of Associated Utility Services, Inc., testified in this proceeding with respect to the fair and reasonable rate of return which the Company should be permitted an opportunity to earn on the fair value of its property.

In determining Potomac Edison's fair rate of return, Mr. Hanley utilized the expected capital structure ratios at year-end December 31, 1976. In this regard, he noted that the capital structure ratios expected at December 31, 1976 are more indicative of the near-term future, the period of time any new rates would be in effect. Potomac Edison's capital structure at December 31, 1976 consisted of 53.0 percent long-term debt, 13.0 percent preferred stock and 34.0 percent common equity.

Mr. Hanley determined that the Company's weighted cost of debt and embedded cost of its preferred stock would be 7.48 percent and 7.57 percent, respectively, as of December 31, 1976.

With respect to the cost of common equity, the witness stated that a market-determined cost rate is the most significant indicator in arriving at a cost rate for this capital structure item. However, there is, he said, no single method through which a proper cost rate for common equity capital can be precisely determined; the proper cost rate is the result of informed judgment based upon an evaluation of all possible criteria.

Since Potomac Edison's stock is not publicly traded, Mr. Hanley analyzed several groups of utility companies whose stocks are publicly traded. These utility companies were used by the witness as guides to the determination of proper cost rate for the common equity capital financed portion of Potomac Edison's Maryland jurisdictional rate base.

In determining the appropriate cost of common equity, Mr. Hanley reviewed and considered "comparable earnings". However, he stated that to adopt comparable earnings of other similar risk utilities would be to engage in circular reasoning. Regulation is, he said, a substitute for competition in the marketplace and it is, therefore, important to look at unregulated enterprises operating freely in the marketplace in order to arrive at a judgment as to the propriety of comparable earnings.

Mr. Hanley also utilized several other methods in determining the cost rate for common equity capital. These other methods included consideration of earnings/price ratios, earnings/net proceeds ratios and discounted cash flow.

Based upon his analysis of the various financial data, Mr. Hanley concluded that the Company's cost rate of common equity is not less than 15 percent, relative to Potomac Edison's prospective common equity ratio of 34 percent. In arriving at his conclusion, the witness gave greatest emphasis to the market-determined data which he studied, and the techniques which were outlined in his testimony.

When the previously established cost rates for Potomac Edison's debt (7.48 percent), preferred stock (7.57 percent) and common equity (15.00 percent) are combined with the Company's estimated capital structure at December 31, 1976, the resultant overall rate of return is 10.04 percent.

In this proceeding, Potomac Edison is seeking an overall rate of return of 9.5 percent. An exhibit was introduced through this witness which indicated the maximum likely achieved financial ratios if Potomac Edison's full rate request is granted. The indicated coverages are 3.2 times and 2.1 times interest charges before and after income taxes, and 1.7 times overall coverage of interest charges and preferred dividends. The likely achieved return on the common equity financed portion of the Company's rate base is 10.4 percent.

With respect to the appropriate rate base to be used with his rate of return recommendation, the witness stated that during the prospective period of time, as rate base increases over the rate base used in this proceeding, the likelihood of earning a fair rate of return diminishes. The severity of such situation is compounded even more by the use of an average rate base. Consequently, Mr. Hanley urged the adoption of a terminal rate base, and his recommendation with respect to the cost of capital was predicated upon the use of such a rate base.

The next witness to testify on behalf of the Company was V. Dean Gibson, Director of Rates for Allegheny Power Service Corporation.

Mr. Gibson began his testimony by describing how various items of the total Company rate base, operating revenues and operating expenses were allocated to Potomac Edison's jurisdictional operations in Maryland. In this regard, he noted that the separations which were used in this proceeding utilized the same procedures that were presented in the Company's last two rate proceedings.

With respect to the adjustment which was made to Potomac Edison's operating revenues and expenses in order to eliminate certain short-term sales, Mr. Gibson stated that transactions between the APS companies and adjacent utilities are administered by APS and that each operating company shares in the benefits of these transactions in accordance with the terms of the Power Supply Agreement. During the test year, a sale was made by APS to GPU which fell into the category of a short-term sale. As a result of the unusual nature of the GPU transaction and the fact that it will not occur again, it is necessary, in this witness' opinion, to analyze this transaction with a view toward normalizing the test year results. In this regard, an adjustment was made to remove the revenues and the cost of producing the electricity which was sold from the test year. However, if that sale had not taken place, the System would have had capacity available with which to make additional economy sales. Accordingly, Mr.

Gibson imputed an economy transaction in excess of actual sales and Account 555 was credited with the additional revenues and debited with associated expenses.

According to this witness, in developing the rate schedules which were filed in this proceeding, the Company endeavored to design a set of rate schedules that would produce the revenue requirements of Potomac Edison. In addition, the Company attempted to distribute the proposed increase among the customers served under various rate schedules in accordance with appropriate criteria such as quantity consumed and method of use. The principal changes in the tariff have been, he said, the repricing of all schedules to reflect approximately the same general level of increase.

Potomac Edison has six special contracts on file with the Commission. The contracts with Westvaco, Celanese and Kelly-Springfield contain rates which are identical to those in Schedule "PP"; these rates were increased to the same level as the "PP" rates.

Service is supplied to Eastalco under a separate electric service agreement which is filed with the Commission. A special rate for this customer was necessary, he said, because of the unique size and nature of its electric requirements. The special service agreement with Eastalco recognizes certain variables by including escalation factors for specified changes which occur during the life of the agreement. The agreement also provides that Eastalco would receive the same percentage rate increase required of other industrial customers, after an adjustment is made to eliminate any increased or decreased costs which Eastalco is already experiencing as a result of the escalation factors in the contract.

The other two special contracts are applicable to sales made to Hagerstown and Frederick for street lighting and traffic signals.

David W. Meese, Senior Vice President of Mercantile Safe Deposit and Trust Company (Mercantile), testified in this proceeding with respect to the institutional investors' viewpoint toward electric utilities in general and toward Potomac Edison in particular.

According to this witness, the electric utility industry occupied a position of generally high regard by institutional investors throughout the post-war period until about 1965. Between 1965 and 1974, however, the financial position and operating performance of the electric industry severely deteriorated and the financial integrity of a number of companies was placed in doubt. Since 1974, the electric industry's position has improved somewhat as a result of an easing of credit market conditions and the granting of rate relief in a number of jurisdictions. Mr. Meese stated that, although a modest improvement in the utility industry's financial condition has occurred since 1974, the industry still remains in a deteriorated condition in an absolute sense. Despite recent improvement in market performance, utility stock price earnings ratios remain, he said, at a substantial discount to industrial companies after years of selling at a premium. This reflects, he said, the higher financial and business risk investors now perceive as being inherent in the utility industry.

In making an investment decision with respect to utility bonds and common equity, Mercantile applies the traditional standards which are applicable to industrial companies, and a few other standards which are peculiar to regulated industries. Mercantile seeks to invest in utility companies whose return on rate base exceeds 9 percent, depending upon use of fair value or original cost, accounting techniques and content of rate base. In addition, it believes that a 14 percent or higher achieved return on common equity is necessary, depending upon capitalization ratios and stockholder reporting practices.

With respect to utility bonds, Mercantile's policy is to invest in bonds bearing a rating of A or better. In addition, it attempts to anticipate, he said, rating changes through an analysis of operations and regulation.

Mr. Meese then testified with respect to how Potomac Edison's securities compare to these criteria. In this regard, he noted that for the year 1976, the operating and financial standards used by Mercantile for both bonds and equity were generally being met, although minimally. However, the witness maintained that the investor must include more than one accounting period in his examination and an exhibit which was introduced through this witness indicated that the Company's projected Maryland results for 1977 fall substantially below the standards of investment used by Mercantile. In this regard, he noted that pre-tax interest coverage will fall to 1.9 times, as compared to the standard of 2.75 times, and return on common equity will decline to 4.6 percent, as compared to the standard of 14.0 percent.

The proposed rates which have been filed in this proceeding by Potomac Edison are designed, he said, to improve the financial condition of the Company. According to Mr. Meese, only if the Commission grants the full rate increase in this proceeding, and only if such relief is effective for the full calendar year of 1977, would the financial results for the Company's Maryland operations be sufficiently improved to meet the investment standards imposed by Mercantile; even with the full rate relief, the return on common equity is, he said, only minimally acceptable under Mercantile's standards.

For the Office of People's Counsel.

The first witness to testify on behalf of the Office of People's Counsel was Matityahu Marcus, Professor of Economics at Rutgers University. Dr. Marcus testified in this proceeding with respect to the rate of return which Potomac Edison should be permitted an opportunity to earn on the fair value of its property.

In arriving at an opinion with respect to the fair and reasonable rate of return for the Company, the witness considered the rates of return earned by unregulated firms (Standard and Poor's 400 Industrials), as well as the returns earned by other electric utilities. However, unless strict comparability can be established, it is preferable, he said, to consider the earnings experience of large and representative groups of utilities which have not been gathered for use in any particular rate proceeding. In this regard, Dr. Marcus examined the returns for Moody's electric utility group, the returns for all Class A and Class B electric utilities, and the returns for the 32 largest utilities as reported by *Value Line*. The witness also examined the returns of Potomac Edison and APS over the same period of time.

Through this witness, an exhibit was introduced which indicated that the returns for recent periods of each of these groups of utilities averaged from a low of 10.78 percent to a high of 12.05 percent, depending upon the group and the period. Generally, APS earned more than the electric industry groups, while Potomac Edison's returns were somewhat lower than the average.

In addition, Dr. Marcus also used the Discount Cash Flow (DCF) method as a guide for determining the required return on equity. He applied this method to APS, which supplies Potomac Edison with equity capital and whose stock is actively traded on the New York Stock Exchange, and to the 32 largest utilities which are reported by *Value Line*. In applying this model to APS, Dr. Marcus noted that the average monthly dividend yields offered by APS common stock have varied over different past periods of time from 7.84 percent (the 6-month period November 1976 to April 1977) to 8.50 percent (the 52-month period January 1973 to April 1977). In calculating the cost of equity under this method, the witness employed 8.33 percent as the dividend yield; it is the average of the yields experienced over the longer, and more variable, market cycle which began in January 1973

and the yields which have been experienced over a shorter, more recent period (the 12-month period ended April 1977).

According to Dr. Marcus, there is no method for determining with certainty the growth expectations of investors. However, under the DCF method, growth expectations are considered explicitly and separately and are then added to the dividend yield. The witness examined year-to-year changes and growth rates of several variables for periods of varying lengths in order to determine the growth prospects for APS. In Dr. Marcus' opinion, the investors' dividend growth expectations for APS lies within the range of 3.3 percent to 3.6 percent.

Based upon a dividend yield of 8.33 percent and a growth rate of 3.3 percent to 3.6 percent, the indicated bare bones cost of equity for APS lies within the range of 11.63 percent to 11.93 percent.

In applying the DCF method to the 32 largest utilities included in *Value Line* reports, the witness used a dividend yield of 8.53 percent, which is the average of the yields for the 52-month period ended April 1977, and the most recent 12-month period. Using this dividend yield and an expected growth rate which falls within the range of 2.53 percent to 3.12 percent, the indicated "bare bones" cost of equity for the *Value Line* 32 utilities is between 11.06 percent to 11.65 percent.

However, the witness maintained that it is necessary to allow higher returns than the bare bones cost of equity in order to compensate for the selling costs of new equity issues; when a company issues new equity, it incurs various selling costs and the price at which it sells the new issues may temporarily decline. Accordingly, Dr. Marcus made an allowance for these factors and determined that, under the DCF method, the indicated cost of common equity to APS was between 12.31 percent to 12.61 percent, inclusive of selling costs. The indicated cost rate for the 32

largest utilities reported by *Value Line,* he said, lies between 11.75 percent and 12.34 percent.

In his study relating to the return on common equity which the Company should be permitted an opportunity to earn, the witness considered the earnings experience of regulated and unregulated firms; the relationship of price-to-book and the return premium above bond yields; and a DCF analysis for APS and for the 32 largest *Value Line* utilities. Based upon these studies, he concluded that Potomac Edison should be permitted an opportunity to earn a return on common equity of 12.3 percent to 12.6 percent.

Dr. Marcus then testified with respect to the appropriate capital structure for the Company and the overall rate of return which it should be permitted an opportunity to earn. In this regard, he noted that Potomac Edison is a wholly-owned subsidiary of APS, and that there are significant financial, operational and managerial links among the members of APS. As a result, it is reasonable to conclude, he said, that investors view APS as a unified economic and financial entity.

Consistent with the Commission's decision in Case No. 6786, Dr. Marcus recommended a rate of return based on the System's consolidated capital structure. The embedded costs which he used with the consolidated capital structure were the System's embedded costs. Dr. Marcus noted, however, that the equity ratios of APS and Potomac Edison are not significantly different (35.38 percent and 33.95 percent, respectively), and that both are close to the electric industry's average.

The witness recommended an overall rate of return in the range of 8.91 percent to 9.02 percent. In arriving at this recommendation, Dr. Marcus did not take into account the cost-free capital reserves available to the Company on the assumption that they would be recognized through appropriate adjustments to Potomac Edison's rate base.

Dr. Marcus also presented testimony which was in the nature of rebuttal to the testimony of Company Witness Hanley. For example, Dr. Marcus maintained that Mr. Hanley's DCF study exhibits major flaws which render his results meaningless. In this regard, he noted that in employing a dividend yield for 1975, Mr. Hanley has ignored the more recent dividend yields which were experienced in 1976.

Since utility stock prices have risen sharply since 1975, Mr. Hanley's 1975 dividend yield will produce, he said, upward biased results. In addition, Dr. Marcus noted that Mr. Hanley did not perform a DCF analysis of APS, even though its stock is actively traded.

The next witness to testify on behalf of the Office of People's Counsel was Charles E. Olson, an economist with the firm of H. Zinder & Associates, Inc. In this proceeding, Dr. Olson testified with respect to what constitutes fair and reasonable rates for sales of electricity to Eastalco.

Eastalco is served, he said, pursuant to a special contract. This contract provides that Eastalco will be charged under a demand-energy type of rate. Under the agreement, Eastalco pays a demand charge, a fuel adjustment charge, a relatively minor kilovar charge and pollution control and Maryland plant siting charges. The demand charges include energy use at 100 percent load factor; credits are utilized to reduce the bill when usage is at less than 100 percent load factor.

Under the contract, Eastalco is provided electricity from the Potomac Edison System. It is not limited to the output of a particular plant and has the option of terminating service at five-year intervals. The witness maintained that, since, Eastalco has not agreed to purchase the entire output of any of the Company's capacity, it is not entitled to a vintaged rate.

According to Dr. Olson, Potomac Edison's rates to Eastalco are not fair and reasonable since the service is

and always has been priced below cost. Despite the fact that the Company's cost of service study has not yet been completed, there is, he said, a method of demonstrating that the Eastalco rate is below its cost of service; i.e., compare the Eastalco rate with the Schedule PP (Power Service — Large Primary) rate. He noted, however, that the rates themselves cannot be compared in a straightforward manner since the demand charges which Eastalco pays include energy at 100 percent load factor, while the Schedule PP demand charges include no energy usage. In order to make a proper comparison of the two rates, the witness determined what the Eastalco bills in 1976 would have been if service had been provided under Schedule PP. An exhibit which was introduced through this witness indicated that the billings to Eastalco would have been increased by $8,850,000 if it were served under Schedule PP. Dr. Olson recognized that there may be some cost differences in serving Eastalco as opposed to other large industrial customers and that Schedule PP service may be provided at rates that exceed cost to serve. However, he concluded that in all probability, the Eastalco rate is too low relative to the Schedule PP rate.

Dr. Olson recommended that Eastalco should be required to pay a rate which is based upon the Company's cost to serve that load. This information will be available to the Commission, he said, before the case is completed and may be utilized accordingly. A reasonable alternative would be to adjust the Schedule PP rates to the cost to serve those loads and then place Eastalco on that Schedule. In this regard, he stated that Schedule PP is a demand-energy type of rate that gives recognition to load factor and would thus take into account the high load factor characteristics of Eastalco.

Alvin J. Garber, a utility consultant, was employed by the Office of People's Counsel to testify in this proceeding with respect to Potomac Edison's fuel rate adjustment clause. In this regard, Mr. Garber noted that Potomac Edison currently has three different fuel adjustment

clauses: one for wholesale service, one for all retail service except Eastalco, and one for Eastalco. The wholesale fuel rate adjustment clause is subject to the jurisdiction of the Federal Power Commission. The retail service fuel adjustment clause, which is subject to the jurisdiction of this Commission, is in all retail rate schedules with the exception of Eastalco. It is similar, he said, to the wholesale fuel adjustment in that it represents the difference between a base cost of fuel per kWh and a current cost per kWh. However, a study of the formulae will show, he maintained, significant differences between the two. After analyzing the differences between the two fuel clauses, Mr. Garber concluded that the FPC fuel rate adjustment clause is superior and should be adopted as the standard fuel clause.

With respect to Eastalco's fuel adjustment clause, the witness stated that this clause is one of many adjustments which has been written directly into the Eastalco contract. It is a fuel adjustment which is based upon generation at a single station (Hatfield's Ferry). The cost of fuel is the cost at that station and the heat rate (Btu per kWh) is the heat rate for Hatfield's Ferry alone. According to Mr. Garber, the Company has offered no studies to show that the present cost of service warrants a special rate for Eastalco. If Eastalco were served solely from the Hatfield's Ferry generating units or if these units or any part of them were specifically designated for service to Eastalco, then there might be reason for a different fuel adjustment clause. There is no statement contained in the contract which provides that these units are dedicated to serving Eastalco nor is there a provision which states that service will be interrupted when the Hatfield's Ferry plant is down.

The witness stated that Eastalco is not being charged its fair share of system fuel costs and, to the extent that it is not paying its fair share, it is placing an undue cost burden on the other customers of the Company. He recommended that the Commission order a restructuring of the Company's basic rate structure so as to include in the Eastalco contract.

John J. Boland, Associate Professor in the Department of Geography and Environmental Engineering at The Johns Hopkins University, testified in this proceeding on behalf of the Office of People's Counsel with respect to the Company's proposed rate design.

In Dr. Boland's opinion, declining-block rate structures are not cost justified and are themselves the source of significant allocational inefficiency and involuntary transfers of income. Accordingly, he recommended that, as a first step toward effective and well-considered rate reform, all block-type features of Potomac Edison's rate schedules should be eliminated. In this regard, he stated that flat energy charges, demand charges and monthly customer charges could be devised for each of the Company's rate schedules which would leave unchanged the revenues derived from each customer class and which would have minimal impact on individual customers.

According to Dr. Boland, although data is not available for the implementation of marginal cost pricing at this time, when that data is available the Company could use either seasonal or time-of-day differentials in order to implement marginal cost pricing. Since the implementation cost of seasonal rates is negligible, their adoption depends only on the existence of a seasonal cost differential. In this regard, Dr. Boland maintained that, as a result of the winter peaking characteristics of Potomac Edison, such a seasonal cost differential is present and should be employed in this proceeding to design the Company's rates However, the implementation costs associated with time-of-day rates requires, in this witness' opinion, more detailed consideration.

In conclusion, Dr. Boland made the following recommendations: 1) that the Commission require the Company to make certain analyses with respect to determining its marginal costs of service; 2) that the Commission require the Company to resubmit its rate schedules, at an appropriate future time, modified so as to eliminate all

declining-block features and to include monthly customer charges; 3) that the Commission consider applying marginal cost-based rate structures, including seasonal and time-of-day differentiation, to the Company. The implementation of these recommendations would result, in his opinion, in more efficient operation of the Company; in greatly reduced inequities among various groups of customers; in rates which are easily understood; and in rates which provide incentives for conservation of energy. The Company, in turn, would experience more stable earnings and less frequent requirements for rate revision.

Donald J. Trawicki, a partner in the firm of Touche Ross & Co., testified in this proceeding on behalf of the Office of People's Counsel with respect to the test year revenue requirements of Potomac Edison.

In reviewing the Company's presentation, Mr. Trawicki determined that nine adjustments should be made to Potomac Edison's calculation of its operating income by $256,000 in order to reflect the growth in unbilled revenues from the beginning of the test year to the end of the test year. This adjustment was necessary, he said, since the revenues which were included in operating income do not include the revenues which were associated with power produced and delivered prior to the end of the test year, but billed to customers after the end of the year.

In view of the fact that all of the Company's fuel clause revenues from Eastalco are specifically assigned to Maryland, the fuel expense that is directly tied to those Eastalco revenues must, he said, also be specifically assigned to the Maryland jurisdiction. However, the Company allocated fuel expense only on the basis of MWh sales in each jurisdiction and did not take into account the fact that the fuel adjustment clause, which was designed to recover those fuel expenses, was on a different basis for Eastalco than for the Company's other customers. Accordingly, Mr. Trawicki prepared a revised allocation in which he directly assigned the Hatfield's Ferry fuel expense to Maryland.

The witness stated that the Company did not allocate to any jurisdiction a $200,000 tax reduction which corresponded to an over-allowance of tax expense in prior years. As a result, he made an adjustment which amortizes the Maryland jurisdictional portion of that tax reduction over a two-year period, thereby increasing Potomac Edison's net operating income by $52,030.

In computing the embedded cost of debt for determining its cost of capital, the Company has used the interest cost of all debt that was outstanding at the end of the year. However, the annualized interest costs associated with a new issue of debt were not reflected in its calculation of income taxes. In order to be consistent with the cost of capital calculation, Mr. Trawicki reflected the full annual amount of the interest deduction associated with this new debt issue and reduced the Company's jurisdictional tax expense by $278,890.

As of November 1, 1975, the Company ceased to accrue AFUDC on construction work in progress. Mr. Trawicki stated that in his opinion CWIP should not be included in rate base without a corresponding addition to operating income for AFUDC. Accordingly, Mr. Trawicki recommended that an adjustment be made which would increase test year net operating income by $1,483,200 in order to reflect the amount of AFUDC which should have been accrued during the test year. A related adjustment was made to increase the Company's average rate base by $695,000 and its terminal rate base by $1,588,000.

In this proceeding, the Company eliminated from operating income the benefits derived from its short-term sales to GPU. After reviewing the assumption and calculation underlying the Company's adjustment which eliminated the sales, Mr. Trawicki concluded that, since the reduction of the actual contribution rate to $3.25 per MWh for all economy sales is not supported by actual data presented in this proceeding, and since some of the GPU sales will be replaced by sales to the Company's regular customers at

higher contribution rates, there is no justification for the Company's proposed adjustment.

The Company has also proposed, he said, an adjustment to test year net operating income in order to annualize the effect of wage increases and personnel reductions occurring after the test period, but before the estimated date of the decision in this case. However, as a result of an analysis of the year-to-year productivity increase in 1975 and 1976, the witness determined that approximately 33 percent of wage increases are offset by productivity increases. In Mr. Trawicki's opinion, it is also necessary to reflect the "productivity savings" which are associated with these wage increases and, accordingly, he increased test year net operating income by $74,000.

Although Mr. Trawicki agreed in principle with the Company's proposal to amortize the estimated expenses of the present rate case over a two-year period, he concluded that when estimated expenses of the current rate case are included an an operating expense, any actual expense incurred during the test year should be removed. Consequently, the witness made an adjustment which increased test year net operating income by $8,000 in order to remove expenses associated with the appeal of the Company's last rate case.

Potomac Edison has made an adjustment which decreased its test year net operating income by $596,000 in order to reflect an increase in the rate of return which is contained in the Power Supply Agreement. Such an adjustment should not be made, Mr. Trawicki stated, since APS has not yet filed an application with the FPC and since there is no indication of whether the entire increase, or any part thereof, will be approved by the FPC. In addition, there is no indication what the impact will be on Potomac Edison if the rate of return in the Power Supply Agreement is increased to 9.25 percent.

After making all of the appropriate adjustments to the Company's presentation, Mr. Trawicki determined that

Potomac Edison had Maryland jurisdictional net operating income of $19,068,000 for the 12-month period ended December 31, 1976.

With respect to the determination of Potomac Edison's rate base, Mr. Trawicki also proposed that several adjustments be made to the Company's rate base calculation.

According to this witness, the Company's calculation of Fuel in Stock does not accurately reflect the inventory of fuel that Potomac Edison had during the test year. In this regard, he stated that during the summer of 1976, the Company discovered that its coal inventory was $714,823 less than the amount it had recorded as inventory on its books. Mr. Trawicki calculated the amount by which book inventory exceeded actual inventory for both the average and terminal rate base, and made an adjustment which reduced the Company's average rate base by $198,000 and its terminal rate base by $86,571.

The witness noted that the Company has established certain operating reserves which should be treated as customer-supplied sources of capital. As a result, Mr. Trawicki made an adjustment which reduced Potomac Edison's Maryland jurisdictional rate base in order to reflect the deduction of the Company's property insurance reserve ($98,000) and its injuries and damage reserve ($263,000).

According to Mr. Trawicki, land which is identified as a site for a future generation station at Point of Rocks, Maryland is not presently being used and the date at which it will be used is undetermined. To insure that ratepayers do not pay for carrying assets which are not required for utility service, amounts representing the Company's investment in this land should be removed from Electric Plant Held for Future Use. Accordingly, an adjustment was made which reduced the Company's average and terminal rate bases by $604,000 in order to remove this item.

In its application, the Company has provided data for both an average and a year-end rate base, but it has requested rate relief based upon a terminal rate base. In Mr. Trawicki's opinion, the use of an average rate base, along with test year revenues and expenses which are properly normalized, results in a proper matching of revenues, expenses, rate base and cost of capital, and provides a sound basis for setting rates for the future. Therefore, the witness recommended that the Commission predicate its revenue requirement determination upon the use of an average rate base for the 12-month period ended December 31, 1976.

However, if a terminal rate base is adopted, Mr. Trawicki proposed that an adjustment be made which would increase test year net operating income by $520,000 in order to reflect the number of customers, and their usage, at the end of the test year. A further adjustment should also be made, he said, in order to reflect the year-end level of AFUDC (increases net operating income by $240,000).

In calculating the Company's cash working capital allowance, Mr. Trawicki made certain adjustments to the Company's determination of this rate base item. First, the witness made an adjustment which reduced the Company's cash working capital allowance by $546,000 in order to reflect the elimination of compensating bank balances. In this regard, he stated that compensating balances do not represent a lag in the receipt or payment of any item, but are a cost of short-term borrowing. As such, they should not be included in the rate base determination.

In addition, Mr. Trawicki stated that the Company's cash working capital allowance makes no provision for the cash-flow benefit which the Company receives from the lag in payment of interest on long-term debt; those funds are available, he said, to the Company as an offset to its cash working capital needs. Accordingly, Mr. Trawicki reduced the Company's Maryland jurisdictional cash working capital allowance by $2,035,000.

Finally, the witness stated that, if the Company's rate base is to include the full amount of CWIP which is recorded at year-end, an allowance must be made in the cash working capital analysis for the lag between the time when construction work is performed and the time when construction bills are paid. This adjustment reduced Potomac Edison's cash working capital allowance by $811,000.

After making all of the aforementioned adjustments to the Company's rate base calculation, Mr. Trawicki determined that Potomac Edison's Maryland jurisdictional rate base averaged $235,909,000 for the 12-month period ended December 31, 1976 and was $248,715,000 at December 31, 1976.

For the Staff.

Marshall E. Stokely, the Commission's Chief Auditor, testified in this proceeding on behalf of the Staff with respect to Potomac Edison's operating results during the 12-month period ended December 31, 1976.

Through this witness, exhibits were introduced which set forth his calculation of the Company's fair value terminal rate base as of December 31, 1976, and his calculation of the Company's average rate base for the 12-month period ended December 31, 1976. In calculating the inventories contained in Fuel in Stock and Materials and Supplies, Mr. Stokely used the weighted average for the year. In this regard, he noted that a weighted average should be used because of the controllable and changeable nature of inventories.

With respect to the calculation of the Company's cash working capital allowance, the witness stated that there are three elements which comprise a cash working capital requirement: 1) working funds (petty cash); 2) compensating bank balances; and 3) the cash needed to pay operating expenses.

Compensating bank balances are included in the cash working capital allowance because they are required by banks in order to establish lines of credit. The interest-free funds which are deposited in order to establish these lines of credit must be obtained, he said, from investor-supplied capital. Mr. Stokely reviewed the Company's compensating bank balances calculation and concluded that the amount contained therein ($1,050,000) was reasonable.

The witness did not include in his cash working capital calculation amounts representing accrued interest or accrued dividends. In Mr. Stokely's opinion, the purpose of the lag study is to determine how much money the investors must invest in working capital. Both of these items are, he said, internal sources of funds, but both belong to the investor and are, therefore, a part of the investment upon which he is entitled a return.

Based upon his review and analysis of Potomac Edison's books and records, Mr. Stokely determined that the Company's rate base was $252,453,000 as of December 31, 1976 and that it averaged $238,941,000 for the 12-month period ended December 31, 1976.

With respect to the determination of Potomac Edison's test year net operating income, Mr. Stokely stated that his presentation differed from the Company's presentation in that he did not make adjustments for changes in the Power Supply Agreement or to reflect wage increases and personnel reductions which occurred after the test year but prior to a decision in this proceeding. As a result, the witness found that the Company had adjusted Maryland jurisdictional net operating income of $16,151,000 for the 12-month period ended December 31, 1976.

In this proceeding, Mr. Stokely recommended that an average rate base be used in determining the Company's revenue requirements. In this regard, he stated that use of an average rate base presents the only proper relationship between the income and the investment upon which the income is earned; to calculate the relationship of net

income to a terminal rate base is comparing earnings which were earned over a period of time to an investment at a single point in time. In this witness' opinion, this presents a distorted calculation. In addition, Mr. Stokely was of the opinion that, as the interval between rate cases has shortened, the Commission is in the position of reviewing the immediate past to set rates for the immediate future. Under these circumstances, an average rate base should be used.

Mr. Stokely also filed an Addendum to his testimony in which he commented upon the various adjustments which were proposed by Mr. Trawicki. The only adjustments which were made by Mr. Trawicki and which Mr. Stokely fully supported were those which reduced Potomac Edison's rate base to reflect the availability of customer advances and customer deposits.

For Eastalco.

James Lim, President of Hess & Lim, Inc., testified in this proceeding on behalf of Eastalco.

According to Mr. Lim, Potomac Edison's agreement with Eastalco reflects numerous, special or unique circumstances and consideration peculiar to providing electric service to the Eastalco aluminum reduction plant. The term of contract, service, power supply, and rate provisions are all interrelated and tailored to Eastalco's special need for service and Potomac Edison's requirements for minimum risk in rendering service.

The Eastalco contract with Potomac Edison contains 12 different provisions for the automatic adjustment to base charges that otherwise would not result from a direct application of the rate. These include automatic adjustments for increases and decreases in fuel costs, tax rates, tax deductions, tax effects, new or discontinued taxes, and changes in Potomac Edison's investment in pollution control facilities for the first and second units at Hatfield's Ferry. All of these adjustment provisions are unique to Potomac Edison's service to Eastalco.

Mr. Lim stated that Mr. Garber's testimony oversimplifies the problem of determining the correct fuel adjustment to be applied to Eastalco. In this regard, he noted that Eastalco does, in fact, have unique service conditions and load pattern which warrant certain differences in treatment from other customers. For example, the Eastalco load is essentially constant and therefore experiences a greater proportion of its consumption, in comparison to other types of customers during those hours of system operation when unit fuel costs are lowest. However, substantial analyses would be involved in order to ascertain the specific effects of this difference in load pattern on the average fuel costs properly applicable to Eastalco in relation to other customers.

Mr. Lim stated that he strongly disagrees with Dr. Olson's recommendation that Eastalco be included on tariff schedule "PP". The difference between the class of customers receiving service under that schedule and Eastalco are, he said, vast and no basis exists for Dr. Olson's conclusion. In this regard, the witness stated that it is readily apparent that schedule "PP" customers are much smaller than Eastalco, have much lower average load factors and generally take service under different conditions. In fact, Eastalco's annual billing demands are more than double the combined billing demands of both schedule "PP" and Special Contract "PP" customers.

In conclusion, Mr. Lim stated that all of the special provisions which are contained in the Eastalco contract are interrelated and intricate parts of the overall arrangement and cannot be properly analyzed on a "piecemeal" basis; it would be inappropriate to require isolated changes without a corresponding reassessment of all the commitments and obligations set forth in the contract terms and conditions.

On cross-examination, Mr. Lim agreed that the rates for service to Eastalco should be based upon the cost to serve that customer. However, he indicated that, at this time,

there was insufficient data upon which to determine whether Potomac Edison was recovering its cost to serve Eastalco.

REBUTTAL TESTIMONY OF WITNESSES

In this proceeding, four witnesses presented rebuttal testimony on behalf of Potomac Edison: Messrs. Hanley, Nicol, Gibson and Kane.

In his rebuttal testimony, Mr. Hanley set forth several areas where he believed that Dr. Marcus had mischaracterized his testimony. In addition, he presented a critique of the DCF methodology which was employed by Dr. Marcus in arriving at his recommendation with respect to the appropriate rate of return on Potomac Edison's common equity.

Mr. Nicol's rebuttal testimony related to the several accounting adjustments which were proposed by Mr. Trawicki. Specifically, he disagreed with Mr. Trawicki's adjustments: 1) to reflect unbilled revenues; 2) to annualize the Company's interest expense; 3) to reflect "productivity savings"; 4) to eliminate $16,000 of rate case expenses; 5) to reflect the continuation of the present rate of return contained in the Power Supply Agreement; 6) to reflect differences between physical and book inventories for the Company's coal piles; and 7) to exclude the value of the land at Point of Rocks from the rate base.

The rebuttal testimony which was presented by Mr. Gibson provided further explanation and justification for the Company's adjustment to eliminate the effect of the short-term sales which it made during the test year to GPU.

The final witness to present rebuttal testimony on behalf of the Company was Donald V. Kane, a partner in the accounting firm of Arthur Andersen & Co.

According to Mr. Kane, it is inappropriate for a company to capitalize AFUDC if it includes CWIP in the rate base.

The two concepts are, he said, intended to fulfill the same basic need, and one concept or the other should be employed. To apply both concepts in a given case could cause, the witness said, the capital cost to be duplicated in the determination of the cost of serving customers.

Over many years of experience with the AFUDC concept, it has become clear, he said, that the use of such accounting procedures is inadequate from a financing viewpoint, and that it is more costly to consumers. The inclusion of CWIP in the rate base generates the cash that is needed to pay the capital service costs and avoids the need to raise additional capital through the sale of securities. In Mr. Kane's opinion, inclusion of CWIP in the rate base is preferrable to the AFUDC concept for the following reasons: it improves cash flow; it is less costly to consumers; it produces a lower level of capital costs; and it results in a lower level of capitalization for productive facilities. Accordingly, he recommended that the Commission include CWIP in the rate base of Potomac Edison, as it has in the other cases, and that it prohibit the capitalization of any AFUDC by the Company.

PUBLIC WITNESSES

Four evening sessions of the hearing in this matter were held throughout Potomac Edison's Maryland service area in order to provide the Company's customers with an opportunity to present their views on the application. These sessions of the hearing were held in the following locations on the dates indicated: Cumberland (May 16, 1977); Frederick (May 18, 1977); Hagerstown (May 25, 1977); and Damascus (June 7, 1977).

Much of the public testimony was related to the Eastalco-Potomac Edison contract. Several witnesses stated that Eastalco should pay the system average for fuel adjustment costs instead of having its rate tied directly to the Hatfield's Ferry Plant. One witness estimated this would increase Potomac Edison's revenues by $4,000,000 per year with no additional costs to the utility.

This witness further stated that an additional $4,000,000 per year could be recovered if Eastalco were charged the system average for capital recovery costs; the resultant $8,000,000 would provide half of the $16,000,000 increase which is being sought by the Company.

Many witnesses were of the opinion that the residential customers of Potomac Edison were "subsidizing" Eastalco. One witness contended that Eastalco's consumption of electricity in 1976 equaled that of all residential users, but that Eastalco only paid $27,000,000, while residential customers paid $81,000,000. It was recommended that Eastalco should either pay its "fair share" or, alternatively, that Potomac Edison stockholders make up the difference. Several witnesses asked the Commission to determine the effect of Eastalco's rates on Western Maryland's economy.

Changes in Potomac Edison's rate structure were advocated to help decrease both costs and consumption. Several of those testifying advocated the elimination of the RA residential rates, while others recommended that special industrial rates be increased. Other rate design proposals included: the implementation of time-of-day pricing, flat rates, or two-tier pricing; the elimination of the current block rates; the establishment of ceilings on the fuel rate adjustment charge; and the approval of lower rates for those utilizing solar energy, windmills and other supplemental power sources. It was hoped that such changes would make it financially attractive for the consumer to use electricity more efficiently.

There was testimony to the effect that lower rates could be obtained if the Company would change or take advantage of certain practices. A lower rate of return was suggested, as was the idea that the Company utilize certain of its tax advantages to the consumers' benefit. One customer recommended that the Commission make certain that Potomac Edison is not charging its Maryland customers for overhead costs already recovered in another state of its or APS' service area.

DISCUSSION AND CONCLUSIONS

Test Year.

In this proceeding, the Company's accounting witness, Mr. Nicol, used data for the 12-month period ended December 31, 1976 in arriving at his revenue requirement determination. People's Counsel's accounting witness, Mr. Trawicki, and the accounting witness for the Staff, Mr. Stokely, also used this same historic test period in developing their respective determinations of Potomac Edison's revenue requirement. In view of the fact that this test period provides the latest available data, the Commission will adopt as the test year in this proceeding, the 12-month period ended December 31, 1976.

Rate Base.

As in the last case involving the rates of this Company, Potomac Edison once again urges the Commission to use a terminal rate base. In this regard, the Company maintains that the uncontradicted testimony in this proceeding establishes that the Company has been subjected to severe attrition and that this attrition will continue into the future. In support of this contention, the Company cited the fact that during the 27 months between the test period in this proceeding and the test period in the last case involving its rates before this Commission, its rate base has increased by 20 to 22 percent, while its return has declined by more than 11 percent, causing an absolute decrease of 26 to 27 percent in the achieved rate of return.

Mr. Stokely and Mr. Trawicki advocated the use of an average rate base contending principally that only the use of an average rate base shows the proper relationship between the net operating income and the investment made to earn it. In addition, Mr. Trawicki noted that the factors which are primarily responsible for attrition, inflation and high interest rates, are not present today to the same extent that they were present during 1974 and 1975. Finally, in Mr. Stokely's opinion, an average rate base should be used because as the interval between rate

cases has shortened, the Commission is reviewing the immediate past to set rates for the immediate future.

In past decisions in rate cases, the Commission has, on a case-by-case basis, used terminal rate bases in some instances and average rate bases in others. See *Re The Chesapeake and Potomac Telephone Company,* 10 P.U.R. 4th 211, 213 (Md. Pub. Serv. Comm'n, 1975) and *Re Potomac Electric Power Company,* Case No. 6999, Opinion, Page 30 (Md. Pub. Serv. Comm'n, December 30, 1976).

In the last case involving the rates of this Company, the Commission adopted the recommendation of its Hearing Examiner and utilized an average rate base. The Commission's use of an average rate base in that proceeding was expressly approved by the Maryland Court of Appeals in *The Potomac Edison Company v. Public Service Commission,* 279 Md. 573, 369 A.2d 1035 (1977). With respect to Potomac Edison's contention that the evidence of attrition was uncontradicted and required the use of a terminal rate base, the Court of Appeals stated at Page 584 of 279 Md.:

> "However 'uncontradicted' the evidence of attrition might have been, that fact would not be dispositive of the issue [whether to use an average or terminal rate base] before the commission, nor on this appeal . . . Nowhere is it written, moreover, that the commission is bound to accept uncontradicted testimony. *Cf. Public Serv. Comm'n v. Balto Gas & El.,* 273 Md. at 373 ('The Commission thus had before it only one expert's opinion concerning the appropriate rate of depreciation, and could use its expertise to evaluate the expert's testimony and to accept or reject it.')."

Even if the Commission determines that attrition has affected the operations of a particular utility, it is not required, as a result, to utilize a terminal rate base. In this regard, the Court of Appeals stated in *Public Service Commission v. Baltimore Gas and Electric Company,* 273 Md. 357, 329 A.2d 691 (1974):

> "That inflation, attrition, and regulatory lag may exist does not mandate the Commission's use of a terminal rate base to resolve these problems." [citations omitted]

To the extent that the Commission is reasonably convinced of the existence of these problems, "[i]t could have attempted to meet them in various ways", *Baltimore Gas and Electric Company v. McQuaid,* 220 Md. 373, 382, 152 A.2d 825, 829 (1959); also see *Public Service Commission v. Baltimore Gas and Electric Company,* 273 Md. 357, 329 A.2d 691 (1974).

After a careful review of the record in this proceeding, the Commission is of the opinion that the use of a terminal rate base is not justified to compensate for the degree of attrition that we find present. Among the several reasons why the Commission has reached this conclusion are: 1) the fact that regulatory lag has been kept to a minimum through the use of the most current data available; 2) the inclusion of a fair value increment of $1,300,000 in the Company's rate base; 3) the adoption of several adjustments to the Company's test year rate base and net operating income which annualize certain changes occurring during the test period and reflected certain known changes occurring after the test period, but prior to a decision in this case. Consequently, the Commission will, in this proceeding, predicate its determination of the Company's revenue requirement on the use of an average rate base for the 12-month period ended December 31, 1976.

All three accounting witnesses have included CWIP in their respective rate base determinations. Mr. Stokely, however, differs from the other witnesses in his calculation of the appropriate amount of this rate base item in that he reflects inclusion of certain investments in the Pleasants Generating Station as of the date those investments were made, rather than as if they were made at the beginning of the test year. Since one of the reasons for using an average rate base is to portray the Company's actual investment

over a 12-month period, it is more appropriate to give recognition to these investments as of the date they are made. Accordingly, we will include in Potomac Edison's rate base $24,699,000 representing the average amount of CWIP during the 12-month period ended December 31, 1976. For the same reason, we will also use Mr. Stokely's calculation of deferred income taxes ($6,112,000) in arriving at a determination of the fair value of the Company's Maryland jurisdictional property.

Effective November 1, 1975, Potomac Edison ceased capitalizing AFUDC on its construction applicable to Maryland operations. The most important aspect of this change of accounting procedure is that additional income is not imputed to the Company, but rather the full revenue requirement is derived from sales. People's Counsel and OCJ take exception to this change in the Company's accounting procedures and recommend that an adjustment be made to increase the Company's rate base and net operating income by $695,000 and $1,483,000, respectively in order to reflect a continuation of the practice of capitalizing AFUDC.

In *Re Potomac Electric Power Company*, Case No. 6814, Opinion (Md. Pub. Serv. Comm'n, May 31, 1975), the Commission noted at Page 42-43, that the accounting treatment for rate making purposes of AFUDC has an effect on the quality of a company's earnings and that there was a trend away from capitalizing AFUDC. Thereafter, the Commission stated in *Re Baltimore Gas and Electric Company*, Case No. 6851, Opinion, Page 34 (Md. Pub. Serv. Comm'n, December 18, 1975) that:

> "In the long-run, we are of the opinion that the public service companies subject to our jurisdiction should be permitted to improve the quality of their earnings by the gradual phasing out of the practice of capitalizing AFUDC."

In view of this policy which has been previously applied to the other major electric utilities that are subject to our jurisdiction, we conclude that it is appropriate at this time

to permit Potomac Edison to improve its cash flow by ceasing to capitalize AFUDC on construction projects relating to its Maryland jurisdictional operations. Therefore, the adjustment which was proposed by People's Counsel and OCJ in this proceeding will not be made.

In calculating the proper allowance for Fuel in Stock, Mr. Trawicki made an adjustment which decreased the amount of this rate base item by $197,833 in order to eliminate an overstatement of Potomac Edison's coal inventory. In this regard, he noted that during the summer of 1976, the Company determined that its coal inventory was less than the amount which it had recorded as inventory on its books. The Company did not write-down the coal inventory immediately, but wrote off the difference over approximately a 12-month period until the next coal survey was taken. We agree with People's Counsel that the effect of the Company's adjustment for its coal inventory error was to make the amount of the coal inventory carried on the Company's books larger than the amount which the Company actually had in stock. Accordingly, the allowance for Fuel in Stock will be reduced by $197,833. A corresponding adjustment will be made to increase Potomac Edison's cash working capital requirement by $86,571 in order to reflect the increased lag in the Company's recovery of fuel costs which was occasioned by this inventory error.

OCJ contends that the Commission should exclude a portion of the amounts included in Fuel in Stock in order to give recognition to the fact that the customers of Potomac Edison pay for the fuel before it is burned. The evidence on the record, however, clearly establishes that the customers do not, in fact, prepay the Company's fuel stock; the fact that the Company's present fuel rate adjustment clause is based on current estimates of fuel costs does not mean that the customers are paying for the fuel before it is consumed, but only that increases in the base cost of fuel are recognized on a current basis. Consequently, the adjustment which was proposed by OCJ is not warranted.

There are several differences in each witness' method of determining the proper allowance for cash working capital. Mr. Stokely's calculation differs from Mr. Nicol's calculation primarily as a result of the fact that Mr. Stokely did not recognize certain operating expense adjustments which were made by the Company and which reduce the "dollar days" used as a base for calculating expense lag days. After a careful review of the lag studies of each of these accounting witnesses, we conclude that the Company's lag study more accurately portrays Potomac Edison's cash working capital requirement since it gives appropriate recognition to certain test year operating expense adjustments.

Mr. Trawicki did not include in his cash working capital calculation amounts representing compensating bank balances. In this regard, the record in this proceeding shows that during the test year the banks which provide the Company with short-term lines of credit required Potomac Edison to maintain $546,326 in interest-free deposits. The Commission, in previous decisions involving the rates of other public service companies, has recognized that compensating bank balances are a part of a utility's cash working capital requirement. See *Re Baltimore Gas and Electric Company,* Case No. 6985 (Md. Pub. Serv. Comm'n, December 9, 1976), and *Re Potomac Electric Power Company,* 1 P.U.R. 4th 238 (Md. Pub. Serv. Comm'n, 1973). The Commission, in permitting compensating bank balances to be included in the cash working capital allowance, stated at Page 264 of 1 P.U.R. 4th:

> "However, the present day credit situation appears to require that interest-free deposits be placed with banking institutions in order to arrange necessary lines of credit. Under this circumstance, the commission in this proceeding will include compensating bank balances in the rate base."

The evidence in this proceeding clearly establishes that these compensating bank balances are required if the Company is to secure short-term lines of credit. Therefore,

we will include in the Company's cash working capital requirement an allowance for compensating bank balances.

In addition, Mr. Trawicki made further adjustments to the Company's cash working capital determination in order to reflect funds provided by the lag in payment of interest expenses (decreases the cash working capital requirement by $2,035,000) and to reflect the availability of funds which are provided by lags in construction payments (decreases the cash working capital requirement by $811,000).

According to Mr. Trawicki, the Company receives a cash flow benefit as a result of the lag between the time when interest on long-term debt accrues and the time when it is paid. Since this interest lag provides the Company with the use of these funds, Mr. Trawicki maintained that the average lag in the payment of interest expense should be deducted from cash working capital. However, this argument ignores the fact that these funds represent corporate funds which belong unconditionally to the stockholders and cannot be used, without proper compensation, as working capital. See *Re Florida Gas Transmission Company,* 93 P.U.R.3d 477 (FPC 1972).

Consistent with our decision in the last Baltimore Gas and Electric Company rate case,[1] we will not make an adjustment to the Company's cash working capital allowance to reflect lag in the payment of interest on long-term debt.

The same reasoning applies, in our opinion, to the adjustment which was made by Mr. Trawicki in order to reflect the lag in the payment of construction expenditures; it is clear that the funds which are used to finance the construction program are provided by investors and cannot be used as cash working capital.

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[1] *Re Baltimore Gas and Electric Company,* Case No. 6985 (Md. Pub. Serv. Comm'n, 1976).

After reviewing the evidence on the record with respect to the cash working capital allowance issues, we conclude that since the Company's method more closely reflects the conditions existing during the test year, an allowance of $6,750,000 will be made for cash working capital.

All of the parties to this proceeding have agreed that Potomac Edison's rate base should be reduced in order to reflect the availability of customer-supplied capital in the form of Customer Advances and Customer Deposits. Consistent with our decisions in prior rate cases,[2] $481,000 representing Customer Advances and $64,000 representing Customer Deposits will be deducted from Potomac Edison's rate base.

Mr. Trawicki also made an adjustment which reduced the Company's average rate base by $360,461 in order to reflect the availability of cost-free operating reserves which were established by the Company for property damage and personal injury claims.

In the last case involving the rates of Baltimore Gas and Electric Company,[3] the Commission reduced that company's rate base by an amount which represented the funds contained in an operating reserve which was established by Baltimore Gas and Electric Company in order to insure itself against the costs associated with the purchase of energy during major unplanned equipment outages. The operating reserves which are the subject of Mr. Trawicki's adjustment in this proceeding are easily distinguishable from the operating reserves which were considered in the Baltimore Gas and Electric Company rate case. The estimates of Potomac Edison's reserve account are based upon the actual loss experiences of the Company. These accounts represent an attempt to insure that expenses are charged to operations when incurred and

[2] See *Re Baltimore Gas and Electric Company,* Case No. 6851, Opinion, Page 33 (Md. Pub. Serv. Comm'n, December 16, 1975).

[3] See *Re Baltimore Gas and Electric Company,* Case No. 6985 (Md. Pub. Serv. Comm'n, 1976).

not when paid; the maintenance of this reserve account depends on the existence of claims and the actual payment thereon. Accordingly, the Commission is of the opinion that no adjustment is warranted in this proceeding to reflect the availability of these operating reserves.

People's Counsel and OCJ urge the Commission to reduce the Company's average rate base by $604,000 in order to remove from the Company's Plant Held for Future Use account all investment relating to the Point of Rocks site. In view of the fact that the Company does not plan to use this property in the near future, (in fact, the construction of a generating station on this site was not reflected in the Company's most recent Ten-Year Plan) the Commission will reduce Potomac Edison's rate base by $604,000.

Finally, OCJ recommended in its Brief that the Company's rate base be reduced by $90,000 in order to reflect the exclusion of the value of land which is owned by the Company in the vicinity of the Hatfield's Ferry transmission line, but which is not contiguous to that transmission line. In our opinion, this property is not used and useful in rendering service to the public and should be eliminated from the determination of the fair value of the Company's fair value jurisdictional property.

After consideration of all of the evidence relating to the Company's rate base, the Commission finds that the fair value for rate making purposes of Potomac Edison's Maryland jurisdictional property, after treatment of the issues discussed hereinbefore, averaged $238,524,000 for the 12-month period ended December 31, 1976.

Test Year Net Operating Income.

In establishing the test year net operating income in this proceeding, the Commission will resolve each of the issues that have been presented by the parties and make adjustments as appropriate to the Company's calculations.

The first issue to be resolved concerns Mr. Trawicki's adjustment which increased test year net operating income

by $256,000 in order to reflect inclusion of "unbilled revenues" in the Company's Maryland jurisdictional operating revenues. This adjustment relates to the fact that in each December the Company has a small percentage of bills which are not rendered during the year in which the service is provided. However, this revenue is, in fact, collected by the Company and recorded on its books each January. Accordingly, we find no compelling reason to depart in this proceeding from accepted accounting practice which has been consistently recognized by the Commission in previous rate case decisions.

Mr. Trawicki also made an adjustment which increased the Company's test year net operating income by $678,000 in order to directly assign to the Maryland jurisdiction all of the fuel costs which were incurred in the generation of electricity at the Hatfield's Ferry Generating Station. However, two other witnesses for People's Counsel, Dr. Olson and Mr. Garber, testified that the Hatfield's Ferry Generating Station was not dedicated to customers in Maryland. Since the needs of the Company's Maryland customers are supplied by electricity generated on the whole system, it is inappropriate to assign to this jurisdiction the fuel costs of any one generating station.

During 1976, the Company received a $200,000 reduction in its tax expense which was not allocated to any jurisdiction. This reduction in the Company's tax expense was a result of netting 1964-1969 tax refunds against 1972-1973 tax assessments. Mr. Trawicki proposed an adjustment which increased Potomac Edison's net operating income by $52,000 in order to amortize the Maryland jurisdictional portion of this refund over a two-year period. In view of the fact that the tax reduction which is the basis of Mr. Trawicki's adjustment had its genesis outside of the test period, we are of the opinion that it is not appropriate to make this adjustment. It should also be noted that a similar adjustment was rejected by the Commission in the last case involving the rates of Baltimore Gas and Electric Company.[4]

[4] *Re Baltimore Gas and Electric Company,* Case No. 6985 (Md. Pub. Serv. Comm'n, 1976).

According to Mr. Trawicki, the Company has included the cost of its newly issued long-term debt in the embedded cost of debt, but it has not included the tax effect of the interest on that debt in its calculation of revenue requirements. As a result, he proposed that an adjustment be made which increased the Company's net operating income by $279,000 in order to reflect the income tax effect of this new issue of long-term debt.

However, Mr. Trawicki's adjustment was based upon the capital structure and cost rates of Potomac Edison and not APS. Although it may be appropriate, under other circumstances, to make such an adjustment, since we are not employing the cost rates and capital structure of Potomac Edison, for reasons set forth in the rate of return section of this Opinion, we will not make this pro forma adjustment to income taxes which was derived from Potomac Edison's cost rates and capital structure.[5]

During the test year, the Company made certain short-term sales to GPU when the latter experienced a capacity deficiency as a result of the unavailability of two nuclear generating plants on its system. The Company and Mr. Stokely made an adjustment which decreased test year net operating income by $378,000 in order to reflect the elimination of these short-term sales. This adjustment also reflects the estimated increase in economy sales which would have occurred but for the sale to GPU.

We agree with the Company that this sales transaction was abnormal and that the test year operating results should be adjusted accordingly. The evidence on the record in this proceeding indicates that the size and duration of the sale was abnormal and that it is unlikely that APS will have sufficient capacity to meet such a request if it

[5] Mr. Nicol indicated in his rebuttal testimony that if the APS capital structure and cost rates were employed, the adjustment proposed by Mr. Trawicki would increase test year net operating income by approximately $10,210. This figure, while disputed by People's Counsel, would appear to indicate that any adjustment based upon APS' capital structure and cost rates would have a *de minimus* effect on the Company's revenue requirement.

should occur in the future; APS was able to supply the needs of GPU primarily as a result of the fact that its Harrison Generating Plant was available 89.6 percent of the hours during the course of the test year, as compared to the industry average availability of 68.7 percent.

A review of the assumptions and calculations underlying the adjustment which was made by Mr. Stokely and Mr. Nicol to eliminate the GPU sales from the test year indicates that the proposed adjustment properly reflects what would have occurred in a normal test year. Accordingly, the treatment which was accorded to this item by the Staff and the Company will be reflected in our determination of Potomac Edison's test year net operating income.

Mr. Nicol made adjustments to test year net operating income in order to reflect an annualization of wage increases occurring during the test year (decreases net operating income by $84,601) and to reflect an annualization of personnel reductions occurring during the test year (increases net operating income by $37,484). Since both of these adjustments appear to be reasonable and were, in fact, made by all three accounting witnesses, they will be accepted for rate making purposes in this proceeding.

Mr. Nicol also proposed that adjustments be made in order to reflect wage increases occurring after the test year but before a decision is rendered in this proceeding (decreases net operating income by $325,000) and to reflect personnel reductions occurring after the test year but before a decision is rendered in this proceeding (increases net operating income by $33,000). Mr. Stokely did not make either of these adjustments. Mr. Trawicki recommends that if the Commission accepts these two adjustments, a further adjustment should be made which increases test year net operating income by $74,000 in order to reflect "productivity savings".

In previous decisions, the Commission has made adjustments to test year operating results in order to reflect

changes in costs occurring during the test year but not reflected in test year data and changes in costs occurring subsequent to the test year but prior to or contemporaneously with the effective date of the rate increase. See *Re The Chesapeake and Potomac Telephone Company of Maryland,* 1 P.U.R. 4th 113, 135-136 (Md. Pub. Serv. Comm'n, 1973) and *Re Potomac Electric Power Company,* 1 P.U.R. 4th 238, 266 (Md. Pub. Serv. Comm'n, 1973). In this proceeding, there is no evidence on the record which indicates that the wage increases and personnel reductions which are the subject of these two adjustments have, in fact, occurred to the extent anticipated by the Company in those adjustments. Based upon the record before us, we conclude that these proposed adjustments are speculative and should not be accepted.

By letter dated July 14, 1977, APS was informed by the Federal Power Commission that it had accepted the amendment to the Power Supply Agreement which was filed by APS on June 8, 1977 and that the amended Power Supply Agreement would be permitted to take effect on July 1, 1977. As a result, the rate of return contained in the Power Supply Agreement has been increased from 8.0 percent to 9.25 percent effective July 1, 1977.

Mr. Nicol made an adjustment which decreased test year net operating income by $597,000 in order to reflect the increase in the rate of return contained in the Power Supply Agreement. However, neither Mr. Stokely nor Mr. Trawicki made this adjustment in arriving at their respective determinations of the Company's test year net operating income.

Since this change in the Power Supply Agreement is a known change which has occurred prior to our decision in this proceeding and since the adjustment which was proposed by the Company will, in our opinion, reasonably reflect Potomac Edison's operating results under the amended Power Supply Agreement, the Commission will reduce the Company's net operating income by $597,000 in

order to reflect this revision in the Power Supply Agreement.

The Company has included in its test year operating expenses approximately $16,000 which represents expenses associated with the appeal of Potomac Edison's last rate case. In addition, the Company has proposed that an adjustment be made which amortizes the estimated cost of this rate case over a two-year period.

Mr. Trawicki maintains that an adjustment should be made which reduces Potomac Edison's test year net operating income by $8,000 in order to remove the actual expense from the test year operating results. Otherwise, he stated, the rate case expense will be duplicated. In view of the fact that the expenses associated with the appeal of the Company's last rate case are a proper cost of doing business and are separate and distinct from the expenses which have been incurred in connection with this proceeding, there is no duplication of rate case expense and it is unnecessary to adopt the adjustment recommended by Mr. Trawicki.

In view of the fact that the Commission has reduced the Company's rate base by deducting customer deposits, the related adjustment to operating income must also be made. Accordingly, Potomac Edison's test year operating income will be reduced by $2,000.

Since the Commission will employ an average rate base, it will be unnecessary to consider two adjustments which were proposed by Mr. Trawicki. The first adjustment would increase test year net operating income by $240,000 in order to reflect the year-end level of AFUDC. The second adjustment concerns Mr. Trawicki's proposal to increase net operating income by $520,000 in order to reflect the number of customers, and their usage, at the end of the test year.

Finally, OCJ recommended that an adjustment be made to reflect refunds which were received by Potomac Edison

as a result of a previous action of the Federal Power Commission with respect to the Power Supply Agreement. This refund related to a change in the rate of return in the Power Supply Agreement which the Federal Power Commission permitted to take effect, subject to refund, on November 1, 1970. Subsequently, on June 1, 1973, the Federal Power Commission reduced the rate of return from 9.0 percent to 8.0 percent and ordered a refund.

We are of the opinion that it is not appropriate to make this adjustment for several reasons. First, during the period beginning with the time Potomac Edison received the refund until the present rate case, it has been consistently unable to earn the rate of return authorized by the Commission. Accordingly, the Company has not realized, as a result of this refund, a return on its investment which has exceeded the rate of return authorized by the Commission. In addition, the refund occurred in 1973, which is more than three years beyond the test year in this case.

As a result of making all of these adjustments to the Company's presentation, the Commission finds that Potomac Edison had adjusted Maryland jurisdictional test year net operating income of $15,555,000, which is calculated as follows:

Company's calculation of Net Operating Income	$15,265,000
Adjustments to Company's calculation	
1. Wage increases occurring after test year	325,000
2. Personnel reductions occurring after test year	(33,000)
3. Interest on Customer Deposits	(2,000)
Commission's calculation of Adjusted Net Operating Income	$15,555,000

Rate of Return.

The Commission has stated in previous decisions what the controlling legal principles relative to rate of return are. Essentially, these principles are stated in two U. S. Supreme Court cases, *Bluefield Water Works and Improvement Co. v. Public Service Commission,* 262 U.S. 679 (1923), and *FPC v. Hope Natural Gas Co.,* 320 U.S. 591 (1944). The relevant sections of these decisions have been quoted in other Commission decisions (See *In Re Potomac Electric Power Company* — Case No. 6658, and *In Re Baltimore Gas and Electric Company* — Case No. 6766), and will not be repeated here.

Presentations on fair rate of return were made by Frank J. Hanley for the Company and Matityahu Marcus for the Office of People's Counsel. Both of these witnesses used the cost of capital approach, and as the following comparative table illustrates, differed materially only as to the cost of equity capital, based on APS capitalization and costs.[6]

Company

Component	*Weighted Ratio*	*Cost Rate*	*Cost*
Debt	51.0%	7.08%	3.61%
Preferred	13.6%	6.99%	.95%
Common	35.4%	15.00%	5.31%
			9.87%

[6] Mr. Hanley testified that he believed that the use of consolidated capital structure ratios and cost rates is incorrect. The actual capital structure for the Company at October 31, 1976 was 53 percent long-term debt, 13 percent preferred stock, and 34 percent common equity. Cost rates for debt and preferred were 7.48 percent and 7.57 percent respectively which, when coupled with his recommended 15 percent return on common equity resulted in a weighted cost of capital of 10.04 percent. The Company does not concede that the capital ratios and debt costs of APS should be the controlling factors, but does accept that the cost of debt and preferred stock capital and a proper capitalization ratio are not issues in this case.

People's Counsel

Debt	51.02%	7.085%	3.61%
Preferred	13.60%	7.011%	0.95%
Common	35.38%	12.3-12.6%	4.35-4.46%
			8.91-9.02%

In Case No. 6445,[7] involving the rates of Potomac Edison and concerning the issue of capital structure, the Commission said:

> "Inasmuch as all of Potomac's capital stock is carried by the parent corporation, Allegheny Power System, it appears that the capital structure of Potomac is at the option of APS. We agree with Witness Kosh in his position that a purchaser of a Potomac Edison bond knows that Allegheny Power System will not stand by and allow Potomac Edison to default. We further agree that the safety of Potomac's equity is not influenced by that company's capital structure, since an equity investment in Potomac is but a portion of the equity of APS. We are therefore of the opinion that under the circumstances in this case it would be proper to consider the capital structure of APS in testing the reasonableness of the proposed rates."

Furthermore, the use of the capital structure of the parent company was upheld by the Court of Appeals in *The Potomac Edison Company v. Public Service Commission*, 279 Md. 573, 369 A.2d 1035 (1977).

The Commission in this case also adopts the cost rates and capital structure of APS as the cost rates and capital structure of Potomac Edison.

It is now necessary only to resolve the issue of the cost of equity in order to arrive at the cost of capital for the Company.

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[7] *The Potomac Edison Company*, Case No. 6445 (Md. Pub. Serv. Comm'n, 1972).

While the Company's calculation of the cost of capital results in a weighted cost of 9.87 percent, the rates filed with the application would, if permitted to take effect, result in an overall return of 9.72 percent, on an average rate base, as calculated by the Company, and a return of 14.58 percent on equity.

The testimony of the two rate of return witnesses has been thoroughly reviewed earlier in this Opinion and need not here be further discussed. Also, Mr. Meese's testimony representing the viewpoint of a large institutional investor has been previously reviewed herein.

Mr. Hanley concludes that an opportunity to earn a return of 15 percent on common equity is necessary and Dr. Marcus recommends a range of 12.3 percent to 12.6 percent.

The testimony and related exhibits of these witnesses and that of Mr. Meese has provided the Commission with considerable evidence on which to make an informed judgment on the cost of equity capital. From its deliberations, the Commission concludes that a return of 13.0 percent on equity capital is reasonable and proper and that the resulting overall cost of capital of 9.16 percent is the reasonable fair rate of return for Potomac Edison.

When this return is applied to the previously adopted average rate base for Maryland operations of $238,524,000, the result is a net operating income requirement of $21,849,000. When the adjusted test year net operating income of $15,555,000 is subtracted from this amount, it results in a deficiency in net operating income of $6,294,000, which in terms of additional gross annual revenues becomes $12,361,000.

Rate Design.

In this proceeding, the Company has filed revised tariffs which reprice all rate schedules to reflect approximately the same general level of increase. The Company's propos-

al, which is essentially an "across-the-board" rate increase, was supported by Celanese Fibers Company. However, the Office of People's Counsel, relying on the testimony of Dr. Boland, made certain recommendations with respect to Potomac Edison's rate structure. First, it was recommended that the Commission require the Company to conduct certain analyses of its operations in order to determine, among other things, its marginal customer, energy and capacity costs. In addition, Dr. Boland recommended that the Commission require Potomac Edison to eliminate all declining-block features from its rate schedules when it refiles its tariffs pursuant to the Commission's order in this proceeding. Finally, Dr. Boland recommended that in the future, the Commission consider applying marginal cost-based rate structures to Potomac Edison.

The recommendations which were made by Dr. Boland, and which were endorsed by People's Counsel, are essentially the same recommendations which he made in the generic electric rate design investigation (Case No. 6808). Since the Commission plans to render a decision with respect to its generic electric rate design investigation by the end of this month, we will accept the Company's proposal to reprice all of its rate schedules at approximately the same level of increase.

Finally, there was evidence on the record in this proceeding that, as a result of the closing of Schedule RA to new customers in 1975, certain of the Company's all-electric customers receive service under rates which are lower than those which are applied to other all-electric customers. In our opinion, this situation should not be permitted to continue indefinitely, and, accordingly, we will direct Potomac Edison to file a plan, within 60 days of the date of the order entered in this proceeding, for phasing-out the availability of Schedule RA.

Fuel Rate Adjustment Clause.

In this proceeding, People's Counsel, through his witness, Mr. Garber, recommended that Potomac Edison's fuel rate adjustment clause be slightly modified so as to conform with the Federal Power Commission standard fuel clause and that this modified clause be uniformly applied to all of the Company's retail customers, including Eastalco. Based upon the evidence on the record in this proceeding, we conclude that it is in the public interest to adopt this recommendation of People's Counsel.

At the present time, the fuel adjustment clause contained in the Eastalco contract is based upon fuel costs incurred in generating electricity at Potomac Edison's Hatfield's Ferry Generating Station. Since the Hatfield's Ferry Generating Station is not dedicated to serve Eastalco, or any other Maryland customer, a proper fuel clause must be based upon the average system fuel costs. In this regard, every other public service company subject to our jurisdiction calculates its fuel rate adjustment on the basis of average system fuel costs; Eastalco is the only user of electricity in Maryland whose fuel rate adjustment is calculated on any other basis.

Accordingly, we will direct Potomac Edison to file a revised fuel rate adjustment clause which conforms with the Federal Power Commission standard clause and which will be uniformly applied to all customers.

Eastalco Contract.

Both People's Counsel and OCJ questioned the reasonableness of the Company's contract with Eastalco. Based upon a careful review of the record relating to this issue, we conclude that the evidence in this proceeding does not support any change in the Eastalco contract, other than the application of a uniform fuel rate adjustment clause to this customer of the Company.

FINDINGS BY THE COMMISSION

The Commission makes the following findings:

1. That the proper test period for determining the revenue requirement is the 12-month period ended December 31, 1976.

2. That the fair value of the Maryland jurisdictional property of The Potomac Edison Company, used and useful in rendering service to the public, averaged $238,524,000 for the 12-month period ended December 31, 1976.

3. That the reasonable rate of return for The Potomac Edison Company is 9.16 percent and that rates for the future should be based upon this return applied to the rate base of $238,524,000.

4. That the test year net operating income, as adjusted herein by the Commission, is deficient by $6,294,000 in yielding the net operating income required to obtain a rate of return of 9.16 percent.

5. That the rates proposed by The Potomac Edison Company in this proceeding are unjust and unreasonable in that they would yield an excessive return.

6. That an increase in gross annual revenues of $12,361,000 is needed to provide an opportunity to obtain a rate of return of 9.16 percent and to result in rates that will be just and reasonable.

7. That the guidelines specified earlier in this Opinion under "Rate Design" and "Fuel Rate Adjustment Clause" are a reasonable and proper basis for the distribution of the Company's Maryland revenue requirements among its various classes of customers.

An appropriate Order will be entered.

Adjusted Maryland Jurisdictional Net Operating Income For The Twelve-Month Period Ended December 31, 1976

Operating revenues	$105,582,101
Operating expenses	
Operating and maintenance	74,019,151
Depreciation	8,338,108
Taxes other than Federal income	5,386,716
Federal income tax	(192,438)
Investment credit deferred, net	1,691,997
Income taxes deferred	1,934,618
Amortization of deferred taxes	(860,775)
Total operating expenses	$ 90,317,377
Operating income	$ 15,264,724

Maryland Jurisdictional Rate Base At December 31, 1976

Electric plant	$315,327,125
Accumulated depreciation	(71,512,553)
Fuel in stock	6,518,691
Materials and supplies	2,775,858
Working capital	6,662,370
Deferred income taxes	(7,084,298)
Unamortized investment credits	(1,623,364)
Fair value	1,300,000
Total rate base	$252,363,829

MARYLAND JURISDICTIONAL RATE BASE FOR THE TWELVE-MONTH PERIOD ENDED DECEMBER 31, 1976

Electric plant	$297,522,820
Accumulated depreciation	(67,287,038)
Fuel in stock	7,657,218
Materials and supplies	2,659,111
Working capital	6,663,147
Deferred income taxes	(6,435,794)
Unamortized investment credits	(1,662,327)
Fair value	1,300,000
Total rate base	$240,417,135

DISSENTING OPINION

Before The
Public Service Commission of Maryland

Case No. 7038

Filed: August 2, 1977

In The Matter of the Application of the Potomac Edison Company for Revisions in its Electric Rates.

Hatem, Chairman, dissenting

In my opinion, the various provisions which are contained in the contract between Potomac Edison and Eastalco, including the fuel rate adjustment provision, are interrelated parts of the overall agreement and should not be properly changed unless consideration is given to the

effect the proposed change would have on the other provisions in the contract. Accordingly, I would have docketed a separate proceeding, the purpose of which would be to first investigate whether or not the Eastalco contract was properly subject to review and revision by the Public Service Commission and if so determining, then investigate the justice and reasonableness of the Eastalco contract in its entirety.

I am therefore unable to concur in the finding on a portion of that contract with relation to the fuel rate adjustment clause.

Before The
Public Service Commission of Maryland

Case No. 7038

In The Matter of the Application of the Potomac Edison Company for Revisions in its Electric Rate

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SUPPLEMENTAL OPINION OF
COMMISSIONER BARNES

Barnes, Commissioner, (concurring in part and dissenting in part)

Filed: August 2, 1977

I concur with the majority's findings with respect to those issues in these proceedings relating to revenue requirements. However, there are several important matters addressed in the Commission's Opinion and Order upon which I am compelled to express my dissent.

Regarding the subject of rate structure, I am in total accord with the recommendations of Dr. John J. Boland, Ph.D., P.E., who appeared in these proceedings as a witness on behalf of the Office of People's Counsel.

His prepared direct testimony in the present proceeding was confined to considerations of rate structure and in particular to the application of marginal cost principles to the design of rates for the Potomac Edison Company. In subject matter, Dr. Boland's presentation was consistent with his previous testimony in the generic electric rate design case, No. 6808, but with important additions. The additions, which pertain specifically to Potomac Edison, are of primary importance here, but first it may be helpful to review Dr. Boland's general position with respect to rate design.

In his prepared direct testimony (p. 5, lines 14-21), Dr. Boland stated his philosophy with respect to rate design:

> "It is my view that the task of the Commission in utility rate cases is to impose, as far as possible, the same discipline on the regulated utility that the competitive market imposes on unregulated firms, while maintaining control over the firm's return on investment. For this reason, I advocate that the Commission cause prices and charges to be set in the same way that competition would require — equal, in each case, to the relevant marginal cost. That is the sum and substance of my position."

He indicated that the process of moving from the current historical-cost-based declining-block rate structures to other structures based on marginal costs would require certain specific changes. These include the following (page 6, lines 2-12):

1. All block-type rates would be eliminated;
2. Seasonal differentials would apply wherever seasonal differences in marginal cost dictate;

3. Time-of-day differentials would be applied wherever the benefits from so doing exceed the metering and other costs;

4. Rate adjustments necessary to yield desired total revenue would be confined to certain non-marginal charges, rather than applying to any charge;

5. Rate differntials between classes would depend on demonstrated marginal cost differentials, rather than on arbitrary allocations of fixed and joint costs.

Dr. Boland stated that the adoption of these reforms would confer advantages upon the consumers of electric energy, on the electric utility, and on the State of Maryland as a whole. He summarzied the various advantages under eight headings (page 6, line 19 through page 7, line 18):

1. Economic efficiency within the electric utility sector would be promoted — for any fixed input of capital, fuel, labor, etc., the maximum aggregate consumer benefit would be achieved;

2. Costs would be allocated among consumers in accordance with true cost responsibility — each consumer is asked to pay only the additional costs that his or her use imposes on the utility, any residual costs or surpluses can be distributed equitably;

3. Involuntary income transfers among classes or groups of consumers are minimized;

4. Most consumers would realize lower electric bills — the average cost of generation would be reduced;

5. Earnings stability is promoted — since consumers pay only the additional costs associated with the service they use, a decision to use or not use any service leaves the earnings of the Company unaffected;

6. Rates are more easily understood by consumers and provide clear incentives for consumers to reduce wasteful uses and to improve load patterns;

7. These rates conserve energy, especially the scarcest forms, and minimize the environmental impacts of generation; and

8. Clear standards are available for regulatory review of rates — cost allocation does not rest on the use of arbitrary formulae.

Dr. Boland testified that the major improvements to result from the adoption of marginal cost pricing principles by Potomac Edison would relate to a more equitable distribution of charges — costs would be allocated among customers more in accordance with true cost responsibility, involuntary income transfers would be minimized, and more easily understood rates would facilitate the rational and economic use of energy by all consumers. It was also noted that many consumers would realize lower total bills, that the stability of earnings for the Company would be enhanced, and that regulatory review would be based on clear standards and a coherent rate-making philosophy.

With respect to economic efficiency and energy conservation, Dr. Boland noted that, while Potomac Edison's current performance may be relatively better than other utilities, further improvements in these areas can and would result from marginal cost-based rates. In commenting on this point, Dr. Boland stated (page 8, lines 12-14):

> ". . . I would not expect such gains to be as dramatic as for a utility with a lower load factor or one than uses significant amounts of petroleum-based fuels. Still, improvements would occur."

One of the changes necessary to implement marginal cost-based rates would be the elimination of declining block rates. Dr. Boland developed his argument against declining-block rates in some detail, and independently of

his overall argument in favor of marginal cost-based rates. He noted that all parties customarily agree that rates should be cost-based, without necessarily agreeing on which measure of cost is relevant to rates. He further noted that utilities must provide services to all on demand — no particular customer or group of customers can acquire special rights to future utility services. Therefore, customers with the same cost accountability should be able, at any given time, to obtain the same service at the same price. It was shown that declining-block rates preclude this result and, therefore, cannot be said to be cost based. In fact, they amount to "a clear case of price discrimination (in the economic sense of the term) and . . . create involuntary income transfers or cross-subsidies." (Page 10, lines 1-3)

Dr. Boland took note of three major arguments that have been advanced in defense of declining-block rates; the customer cost argument, the capacity cost argument, and the declining cost argument. He stated that the customer cost argument is inconsistent and ignores the actual characteristics of declining-block rates and that, in any case, a preferable method of recovering customer cost is the use of a monthly customer service charge set equal to that cost. The capacity cost argument was shown to be based on obsolete assumptions. The declining cost argument implies a misunderstanding of economic principles, even if one accepts its implicit goal, which is to promote the use of electric energy independent of any consideration of economic efficiency.

With respect to the implementation of marginal-cost-based rates, Dr. Boland discussed three sequential steps: the definition of the relevant marginal costs, the measurement of these costs, and the design of rate structures based on these costs. In defining "relevant marginal cost", three distinct classes of cost were described: customer costs, energy costs, and capacity costs. The appropriate definition

was presented for each class, and the means of measurement discussed. Briefly, measurements of marginal customer cost can be based on existing cost accounting information, marginal energy costs can be measured by analyzing existing generation and transmission data, and marginal capacity costs are determined from analysis of the utility's capital expansion plans. Tests for the existence of seasonal and/or time-of-day cost differential were also outlined, with special attention to the unique characteristics of Potomac Edison's load and the resultant costs. It was observed that, even though Potomac Edison is a winter-peaking company, marginal energy costs are likely to be higher in the summer due to the opportunities for energy exchange with nearby summer-peaking utilities.

The final step in the implementation of marginal cost-based rates is the design of the rate structure. It was emphasized that no single rate structure is expected to emerge from his process as "the best"; a number of alternate structures must be developed and reviewed, with the final choice resting on consideration of many criteria including but not limited to those discussed in this testimony. Dr. Boland suggested that the final design would consist of separate structures for each customer class, each structure consisting of a monthly customer charge and an energy charge. The energy charge would be subject to seasonal differentiation for all customers, and to time-of-day differentiation for those customers now equipped with demand meters as well any others who request, and pay for, the necessary metering equipment. He further noted that the rate structure would include some means for adjusting total revenue to that level permitted by the Commission, after appropriate revue of the Company's historical costs and capital structure. This could take the form of a fixed charge of credit against each monthly bill. The charge or credit would be set at the same time as other elements of the rate structure and could be different for each customer class, provided such class allocation was performed in a manner acceptable to the Commission.

Concluding his prepared direct testimony, Dr. Boland made three major recommendations to the Commission:

1. He recommended that the Commission require certain analyses of the Company, including measurements of marginal customer, energy and capacity costs; definitions of appropriate seasons and peak/off-peak periods for rate differentiation; and estimates of the contributions to system peak of each of the various customer classes.

2. He recommended that the Commission require the Company to re-submit its rate schedules with all declining-block features eliminated, and with customer costs recovered by an appropriate customer charge. As an initial step, Dr. Boland suggested that these revised rate schedules be based on the same revenue allocation among classes as currently approved by the Commission.

3. Finally, Dr. Boland recommended that the Commission consider the future application of marginal cost-based rate structures to Potomac Edison. These structures would include seasonal and time-of-day rate differentiation. This final recommendation is identical with those made by Dr. Boland and by People's Counsel in the still-pending Case No. 6808.

It is my opinion that the Commission should adopt these three recommendations at this time. They accord with my own view that rates for electricity should, to the extent feasible, reflect the actual cost of providing service to each customer at the time at which the customer receives the service.

Regarding the rates that are charged to the Eastalco Aluminum Company, hereinafter referred to as Eastalco, an Intervenor in these proceedings, it is my judgment that this Commission has the authority, pursuant to the doctrine enunciated by the United States Supreme Court in the companion 1956 cases that constitute what has

become known as the Sierra-Mobile Doctrine, to make appropriate adjustments in Eastalco's contract for utility service with the Potomac Edison. *United Gas Pipeline Co. v. Mobile Gas Service Corp.*, 350 U.S. 332, 76 S. Ct. 373 (1956); *Federal Power Commission v. Sierra Pacific Power Co.*, 350 U.S. 348, 76 S. Ct. 368 (1956). Further, I am of the opinion that the instant case presents almost a model example of a factual context in which the Sierra-Mobile Doctrine should be applied. The evidence on the record in this matter is scant, the result of rulings with respect to the admission of certain testimony relating to the Eastalco contract. As I stated at the time those rulings were made by the majority of the Commission, I would have admitted the excluded testimony. I believe that much of the excluded testimony would have proved to be relevant and material to the determination of rate design issues that the Commission must reach in this case. Nonetheless, despite those exclusions, there exists in the record sufficient testimony and data to justify a finding that the rate charged to Eastalco under the existing tariffs provides such a low rate of return to Potomac Edison that appropriate modifications in the contract should be made at this time.

I concur with the testimony of Mr. V. Dean Gibson that the rate of return for all customers of a utility should be within "a reasonable range around the average" experienced by all customers of the utility. Accordingly, it is my view that Potomac Edison should be directed at this time to submit new tariffs covering services to Eastalco that would be designed so as to bring Eastalco into such a "reasonable range."

With respect to the fuel adjustment clause issues raised in this case, I concur with the finding of the majority that a uniform clause should be applied to all customers of Potomac Edison, including Eastalco, as recommended by Mr. Alvin Garber, a witness appearing on behalf of the Office of People's Counsel. It seems to me altogether reasonable to require all customers of a utility to pay the

same average fuel costs that are paid by other customers through the operation of the automatic fuel rate adjustment. It may be, as counsel for Eastalco have asserted, that this adjustment requires other adjustments in the contract, because the contract must be viewed as an entity, not looked at piece meal. Although I may agree with this assertion, it does not follow that no portion of the contract should be altered. The logical approach to this problem would be to review all of the terms of the entire contract in order to assure that the contract, taken as a whole, is just and fair to Potomac Edison, Eastalco, and the other customers of Potomac Edison. This is the action that I would wish to take at this time.

I further concur with the Order of the Commission directing that Potomac Edison institute a fuel clause as proposed by the Hearing Examiner in the generic fuel rate adjustment case now pending before this Commission. I would have gone somewhat further in requiring additional changes to the fuel clause currently on file, but I will reserve my views with respect to those issues for the completion of the generic case.

ORDER NO. 62502

Before The
Public Service Commission of Maryland

Case No. 7038

In The Matter of the Application of the Potomac Edison Company for Revisions in its Electric Rates.

In accordance with the Opinion of the Commission filed herein on the date hereof, which Opinion is hereby

referred to and made a part hereof, it is, this 2nd day of August, 1977, by the Public Service Commission of Maryland,

ORDERED: (1) That the fair value for rate making purposes of the utility property of The Potomac Edison Company, which is allocable to Maryland retail electric service, averaged $238,524,000 for the 12-month period ended December 31, 1976 and such valuation shall be and become final unless protest against the same shall be filed with the Commission within thirty (30) days as provided by Section 72 of The Public Service Commission Law.

(2) That the rate schedules filed in this proceeding on February 2, 1977, by The Potomac Edison Company, are hereby rejected as unreasonable and the Company's proposal to increase its revenues by $16,200,000 is denied.

(3) That the Potomac Edison Company be, and it is hereby, authorized, empowered and permitted to file with the Commission amended schedules of rates for the sale of retail electric service rendered in Maryland by the Company, which shall result in an increase of not more than $12,361,000 in gross annual electric revenues, and said schedules are to be submitted in accordance with the guidelines set forth in the "Rate Design" section of the accompanying Opinion of the Commission.

(4) That the said rate schedules to be filed in accordance with Paragraph (3) shall be subject to acceptance by the Commission and the designation by it of an effective date.

(5) That the Potomac Edison Company shall file a revised fuel rate adjustment clause in accordance with the guidelines set forth in the "Fuel Rate Adjustment Clause" section of the accompanying Opinion of the Commission and said revised fuel rate adjustment clause shall be applicable uniformly to all retail customers of the Company.

(6) That all motions not specifically granted by action herein be, and the same are hereby, denied.

(7) That this Order shall become effective on the date hereof and shall remain in effect until further order of the Commission in the premises.

(8) That The Potomac Edison Company shall, within sixty (60) days of the date of this Order, file with the Commission a plan for the phasing-out of the availability of Schedule RA.

(9) That The Potomac Edison Company shall furnish this Commission with accurate and complete statements under oath, and in convenient form, setting forth the revenues, operating expenses and other expenditures of the Company on a Maryland jurisdictional basis during each monthly period; such reports to be furnished within thirty (30) days following the last day of each monthly period during the period in which this Order remains effective.

By the Commission,

RONALD E. HAWKINS,
Acting Executive Secretary

Chairman Hatem and Commissioners Baldwin and Barnes conducted this proceeding as a three-member panel pursuant to the provisions of Section 20 of The Public Service Commission Law.

Before The
Public Service Commission of Maryland

Case No. 7038

In The Matter of the Application of the Potomac Edison Company for Revisions in its Electric Rates

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BRIEF OF EASTALCO ALUMINUM COMPANY, INTERVENOR

JOSEPH SHERBOW,

EDWARD F. SHEA, JR.

SHERBOW, SHEA & DOYLE

Attorneys for Eastalco Aluminum Company, Intervenor.

July 21, 1977

ARGUMENT

II.

THE REGULATION OF THE EASTALCO CONTRACT IS SUBJECT TO THE CONSTITUTIONAL RESTRAINTS AGAINST IMPAIRMENT OF THE OBJECTIONS OF CONTRACT AND CONSTITUTIONAL GUARANTEES OF DUE PROCESS

During these proceedings, we have maintained that Special Schedule No. 4 is not just a tariff of the Company but constitutes a valid contract between the Company and Eastalco. Regulation of the contract is subject to what has been referred to as the "*Sierra-Mobile*" doctrine.

The question is not simply one of whether every class of customer should pay the same rate of return. As this Commission has stated in a case involving this same utility:

> "It is obvious to us that every rate need not and cannot be expected to produce the same return or a return equal to a utility's overall permitted return. Ordinarily, the returns earned on various services of a utility vary considerably from rate class to rate class, and the overall return earned by a utility is a mix of these varying returns, some being lower than others . . ."
>
> *In the matter of the Proposed Rates of the Potomac Edison Company* — Case No. 6021, 58 P.S.C. 26, 28 (1967)

Moreover, where the rate for a class of customer has been fixed by a contract, the test is even more stringent, and the record in this case does not even approach what is required by the Supreme Court of the United States.

Paragraph 4 (K) of the Electric Service Agreement between the Company and Eastalco prohibits Company from increasing the rate charged to Eastalco unless such increase is made in connection with an application for changes in the level of charges applicable to all industrial customers, and, the increase to Eastalco does not exceed the weighted average percentage of annual revenue increase sought from those industrials. The rate scheme to be applied to Eastalco is fixed by this contract, which clearly is intended to prohibit any unilateral change of the rates specified therein. Although the contract recognizes the rates are subject to the Public Service Commission, that regulation is governed by the constitutional restraints against impairment of the obligations of contract and constitutional guarantees of due process.

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ORDER NO. 62552

Before The
Public Service Commission of Maryland

Case No. 6759

In The Matter of Fuel Rate Adjustment Costs Charged to Customers by Electric Utility Companies.

On April 24, 1974, the Commission instituted, on its own motion, an investigation of the operation of the fuel rate adjustment clauses of Maryland electric utilities. In order to make an in-depth review of these fuel clauses, the Commission held hearings in the service areas of the major electric utilities that generate power; regional hearings were held to review the adjustment clauses of companies that purchase power.

From the sessions of the hearing which were devoted to consideration of purchased power adjustment clauses, the Commission entered a series of orders which required the filing of a revised uniform purchased power clause for each of the distribution companies buying power. In addition, several orders of an interim nature were entered which, for example, directed electric companies to redesign their customer bill forms so as to include, as a separately stated amount the fuel rate adjustment included in the total monthly bill (Order No. 60945), and required those companies that generated electricity to limit the excess cost of fuel to be recovered through their adjustment clauses to those items which are included in Account 151 of the Uniform System of Accounts (Order No. 61148).

On October 4, 1976, the Hearing Examiner, who was delegated the authority to conduct these proceedings,

issued his Proposed Order. Thereafter, the Office of People's Counsel (October 21, 1976), The Easton Utilities Commission (November 1, 1976), and Delmarva Power & Light Company of Maryland (November 1, 1976) noted appeals to the Commission from the aforementioned Proposed Order of Hearing Examiner. Argument on appeal was heard by the Commission on December 1, 1976.

Since the background and a summary of the evidence relating to this proceeding are fully set forth in the Proposed Order of Hearing Examiner, they will not be repeated here.

The Commission, constituted as a three-member panel consisting of three Commissioners pursuant to the authority contained in Section 20(c) of The Public Service Commission Law, having carefully considered the record before the Hearing Examiner, including the arguments of the parties, as well as the arguments before it on appeal, is of the opinion, and so finds, in the public interest.

1. That Section 54 of The Public Service Commission Law provides specific statutory authority to support the legality for the inclusion of the fuel rate adjustment clause in electric utility rate schedules.

2. That a specific or periodic freeze of fuel rate adjustment clause levels should not be imposed.

3. That in calculating the monthly adjustment, the cost of fossil fuel should include no items other than those specified in Account 151 of the Uniform System of Accounts and that the cost of nuclear fuel should be that as shown in Account 518.

4. That the bill form utilized by each of the electric companies should show, as a separately stated item, the dollar amount of the fuel rate adjustment charge, and that such amount should be designated on the customer bill as "fuel cost".

5. That each of the companies should file with the Commission, at least ten calendar days before the effective date, the monthly calculation for the ensuing month's fuel rate adjustment factor for acceptance before implementation.

6. That the Commission's Staff should develop a uniform reporting form which shall be utilized by the electric companies in filing their monthly calculation of the fuel rate adjustment factor.

7. That in filing their monthly calculation of the fuel rate adjustment factor, the electric companies should show separately the price of fuel and delivery charges.

8. That the Audit Review Work Program to be performed in the offices of each of the four generating companies, as developed by Haskins & Sells, is appropriate and should be followed by the Commission's Staff on a monthly basis.

9. That every Maryland generating company, which has a fuel rate adjustment clause on file with the Commission, should use a "zero base" in that fuel clause so that the total amount of the charge for fuel will appear as a separately stated "fuel cost" charge on customer bills.

10. That every Maryland generating company, which has a fuel rate adjustment clause on file with the Commission, should use a fuel clause which conforms with the Federal Power Commission standard clause, as specified in Order No. 517 (FPC Docket No. R-479), and which will be uniformly applied to all customers.

11. That each of the four major generating companies should file an annual report for fuel procurement as specified in Appendix D of the Proposed Order of Hearing Examiner which was filed in this proceeding. This report should be filed coincidentally with the filing of each company's annual report to the Commission.

12. That in reviewing these fuel procurement reports, the Commission's Staff should also review the reports which these companies file with the Federal Power Commission relating to the prices which are paid for fuel used to generate electricity.

13. That the electric companies should notify the Commission when they are advised by one of their fuel suppliers of an increase in the price of fuel which is purchased from that supplier.

14. That Delmarva Power & Light Company of Maryland should refund $125,000 to its retail customers in Maryland.

IT IS, THEREFORE, this 30th day of August, in the year Nineteen Hundred and Seventy-seven, by the Public Service Commission of Maryland,

ORDERED: (1) That the findings, among the Findings 1 through 14, inclusive, as hereinbefore stated, that require implementation, shall be implemented at the earliest practical date and such findings as are already in effect are hereby affirmed.

(2) That all motions not specifically granted by action herein be, and the same are hereby, denied.

THOMAS J. HATEM,
WILLIAM S. BALDWIN,
Commissioners.

DISSENTING OPINION

Before The
Public Service Commission of Maryland

Case No. 6759

In The Matter of Fuel Rate Adjustment Costs Charged to Customers by Electric Utility Companies

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Barnes, Commissioner, dissenting Filed: August 30, 1977.

I respectfully dissent. I oppose the automatic monthly pass-through to the consumer of fluctuations in the cost of fuel purchased by utility companies for use in generating electricity. I believe that such an automatic monthly adjustment amounts to a guarantee that a utility's costs of purchased fuel will be recovered on a current basis, whatever the reasonableness of those costs; and such a guarantee will almost inevitably operate as an economic disincentive to efficiency in the purchase and handling of fuel. The utilization of monthly fuel rate adjustments provides no incentive to utilities to decrease their fuel costs, and the customers are left at the mercy of what amounts to an unregulated segment of the activities of public service companies.

The importance of this issue to consumers in Maryland cannot be overstated. As was noted in the Proposed Order of Hearing Examiner in these proceedings, revenues from retail electric sales in Maryland in 1975 totalled approximately $1,000,000,000. Of that total, approximately $280,000,000 was received by utilities through the operation of automatic fuel rate or purchased power adjustment clauses. In the nation as a whole, utility customers paid $12,700,000,000 more for electric and gas service in 1976

than they did in 1975. Fuel adjustment clauses accounted for $9,600,000,000, more than 75 percent of the increase. Economics Division, Congressional Research Service, Library of Congress, "Electric and Gas Utility Rate and Fuel Adjustment Clause Increases, 1976" Committee Print, Subcommittee on Intergovernmental Relations and Subcommittee on Reports, Accounting and Management, U.S. Senate Committee on Governmental Affairs, 95th Congress, 1st Session, page V (July 1977).

With respect to these charges, and the impact of the automatic monthly adjustments upon them, I concur with the findings of a 1974 study undertaken by D.N. Jones and S. Dovell: "One important — and ultimate — effect is that . . . fuel adjustment clauses remove much of the incentive to operate more efficiently and to control costs. They encourage use of fuels covered by the clause and construction of plants burning those fuels, and thus discourage development of alternative energy sources." D.N. Jones and S. Dovell, "Electric and Gas Utility Rate and Fuel Adjustment Clause Increases, 1974" Committee Print, Subcommittee on Intergovernmental Relations and Subcommittee on Reports, Accounting and Management, U.S. Senate, committee on Government Operations, 94th Congress, 1st Session, page VII (March 27, 1975). Further, when fuel rate adjustments are essentially automatic (that is, subject only to arithmetical verification), they remove the major component of operating costs — fuel costs — from rate case proceedings where the utility is subject to cross-examination.

Given my opposition to the automatic monthly fuel rate adjustment, I feel compelled to discuss the options that are available to this Commission in exercising its responsibility to regulate Maryland's public service companies. The Office of People's Counsel presented two options in its arguments in these proceedings. The first is simple abolition of the clauses that permit the adjustment. The second is modification of the clauses so as to permit the pass-through of only a portion (People's Counsel recommended 75 percent) of the fluctuation in fuel costs.

Both of People's Counsel's recommendations have some merit. Abolishing the fuel rate adjustment would require that fuel costs be treated in the same manner as all other utility operating costs and would provide electric companies with the same incentive to reduce fuel costs that they currently have with regard to other costs. The obvious disadvantage of this approach, however, is that utilities would be subject to severe financial attrition during times of rapidly escalating fuel costs; and consumers would not receive the offsetting benefit of reductions in their monthly bills during times of decreasing fuel costs. It is possible that responsive regulation by the Public Service Commission would be able to overcome the disadvantages inherent in elimination of monthly fuel rate adjustments, but those deficiencies need to be recognized by responsible opponents of such adjustments.

Permitting a monthly pass-through of only a portion of the fluctuation in fuel costs also would provide additional incentive to utilities to reduce those costs. However, during periods of increasing fuel costs, this partial pass-through mechanism would tend to require even more frequent rate cases than are now experienced in Maryland, and the inflexibility of such a system would not appear to be economically justifiable.

An alternative to the automatic monthly fuel rate adjustment that would retain many of the benefits to both utilities and their customers that are inherent in the monthly adjustment while at the same time providing an increased incentive to maximize efficiency and minimize costs is adding a period of time — a lag — in recovery of the fuel costs. The fuel clause methodology adopted by the Commission in its Order in these proceedings permits recovery of fuel costs on an almost current basis, or as close to current as is possible. If a delay in recovery were included in the process, by limiting the adjustment to one that operates quarterly or semi-annually, the ultimate ability of the electric company to regain the fuel costs that it incurred would be assured, and consumers would be

assured that the Company was operating under a system of regulation that provided incentives to efficiency and lowest possible costs. If the pass-through were allowed only after hearings at which the utility's data and procedures were subject to cross-examination and public scrutiny, an added element of public awareness and confidence would be present in the regulatory process.